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Publication 68
Revised 11/11

Pass-through Entity Withholding

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Introduction

This guide provides information to help pass-through entities and pass-through entity taxpayers understand and comply with Utah's pass-through entity withholding requirements that went into effect Jan. 1, 2009.

For tax years beginning on or after Jan. 1, 2009, pass-through entities must withhold Utah income tax on income from Utah sources for nonresident individual partners, members and shareholders, and for resident and nonresident non-individual partners, non-individual members and non-individual shareholders.

Tax Commission publications are reference tools. They are not all-inclusive and should not be used as legal references. For more information, see Utah Code §§59-10-1401 through 1405 and Administrative Rule R865-9I-13.

Tax laws may change due to legislative action. Changes to law will supersede information in this publication.

General Information

A pass-through entity is an entity whose income, gains, losses, deductions and credits flow through to partners, members and shareholders for federal tax purposes. For purposes of Utah withholding, pass-through entities include:

- General partnerships, limited partnerships, limited liability partnerships;
- Limited liability companies if classified as a partnership for federal income tax purposes; and
- S corporations.

Estates and trusts are not considered pass-through entities for Utah withholding purposes.

Pass-through Entity Taxpayers Subject to Utah Withholding

Pass-through entity taxpayers subject to Utah withholding tax are:

- Nonresident individual partners, members and shareholders; and
- All general partnerships, limited partnerships, limited liability partnerships, limited liability companies, S corporations, C corporations, and estates and trusts.

Withholding Requirements

A pass-through entity must withhold a 5% income tax on its:

- Utah business income allocated to its pass-through entity taxpayers; and
- Non-business income derived from or connected with Utah sources allocated to its pass-through entity taxpayers.

Withholding Calculation

The entity uses TC-20S Schedule A (if it is taxed as an S corporation) or TC-65 Schedule A (if it is taxed as a partnership) to arrive at the total Utah income. It then uses TC-20S Schedule N or TC-65 Schedule N to allocate the Utah income and calculate the Utah withholding tax for each pass-through entity taxpayer.

Credits

The only credits that may be used to reduce the withholding are the Utah mineral production withholding credit and Utah withholding from an upper tier pass-through entity that flows down to the pass-through entity. An upper-tier pass-through entity is one in which the taxpayer is a partner, member or or shareholder and for whom the upper-tier pass-through entity withholds and pays Utah income tax as reported on the Utah Schedule K-1.

Other credits, such as the Historic Preservation Credit and the Commercial Energy Systems Credit, along with the allocated Utah mineral production withholding credit and Utah withholding from an upper tier pass-through entity, must be passed through to the pass-through entity taxpayers and claimed on the ultimate pass-through entity taxpayers' income tax returns.

Multi-level Pass-through Entities

A pass-through entity that has another pass-through entity as a partner, member or shareholder is called a first tier or upper-tier entity. The partner, member or shareholder is a second tier entity or a downstream entity. A pass-through entity is directly related to a pass-through entity taxpayer if they occupy consecutive tiers.

For example, a first tier entity is directly related to a second tier entity. A second tier entity is directly related to a third tier entity. A first tier entity is not directly related to a third tier entity. Application of these rules is discussed in some of the following examples.

Withholding Requirement Exceptions

The following entities may be exempt from withholding:

- A publicly traded partnership meeting the requirements of Utah Code §59-10-1403.2(1)(b)(iii) is not required to withhold tax on its partners. However, a publicly traded partnership that is a downstream entity is not exempt from having money withheld on Utah income allocated to it by an upper tier entity, and therefore, may have Utah withholding it needs to allocate and pass-through to its partners.
- A pass-through entity is not required to withhold tax on behalf of a directly related pass-through entity taxpayer if that taxpayer is exempt under Section 59-7-102(1) provided the income is not unrelated business income. Section 59-7-102(1) includes IRC §501 entities, such as religious and charitable organizations, and IRC §528 homeowners associations, insurance companies taxed under Utah insurance tax laws and farmer's cooperatives.

  ▷ **Example 1:**

  Partnership A is an LLC with Utah business income. It has three partners. Partner #1 is a homeowner's association under IRC §528, Partner #2 is an S corporation, and Partner #3 is a nonresident individual. Partnership A is not required to withhold Utah tax for Partner #1 as long as Partner #1 is not required to treat the income as unrelated business income. Partnership A must withhold on behalf of Partners #2 and #3.*

- An individual retirement account (IRA) as defined under IRC §408(a) is exempt from withholding only if the IRA is not required to treat the income from the pass-through entity as unrelated business income.

  ▷ **Example 2 :**

  Partnership A has two partners and Utah business income. Partner #1 is an IRA, and partner #2 is an LLC that is not a disregarded entity. Partnership A is not required to withhold Utah tax for Partner #1 as long as Partner #1 is not required to treat the income as unrelated business income. Partnership A must withhold Utah tax on behalf of Partner #2.*

- A real estate investment trust (REIT) is exempt from withholding if all of its earnings are distributed to the owners of the REIT.

  ▷ **Example 3:**

  Partnership A is an LLC with Utah business income and has two partners. Partner #1 is a REIT that distributes all of its earnings to its owners, and partner #2 is an S corporation. Partnership A must withhold Utah tax on behalf of its S corporation partner but does not need to withhold Utah tax on behalf of its REIT partner* because the REIT distributes all of its earnings to its owners.

*See *Waiver of Withholding Tax* on page 3

▷ **Example 4:**

Partnership B has Utah business income and two partners who are both partnerships. Partnership B is a first tier entity. Partner #1, a partnership, has a partner that is a REIT. Partner #2 is a partnership whose partners are all Utah resident individuals. Partners #1 and #2 are both second tier entities. Partnership B must withhold Utah tax for both of its partners, even though a partner of one of its partners (a third tier entity) is a REIT. Partnership B and the REIT are not directly related. Partnership B is only exempt from the withholding requirement if a directly related pass-through entity taxpayer is a REIT, an individual Utah resident, or otherwise exempt.*

- A person exempt from Utah income tax under Utah Code §59-10-104.1 is exempt from pass-through entity withholding from the pass-through entity to whom they are directly related.

▷ **Example 5:**

Partnership A is a family partnership with two nonresident individual partners. Each partner's federal adjusted gross income is less than the sum of the federal personal exemption and the federal standard deduction and as a result, both are exempt from Utah income tax under Utah Code §59-10-104.1. Partnership A is not required to withhold Utah tax for these partners. *Note: Each partner's total income must be below the filing limit, not just the amount of income attributable to Partnership A.*

▷ **Example 6:**

Partnership B has a partner that is a family partnership with some nonresident individuals who meet the exemption from Utah income tax. Partnership B must withhold Utah income tax for that partner.* Partnership B, the first tier partner, is not directly related to the partners of the second tier family partnership.

Disregarded Entities

Entities that are disregarded for federal tax purposes are disregarded for purposes of pass-through entity withholding. See Q-8 in *Frequently Asked Questions* for more information.

Income Subject to Withholding

The following income is subject to Utah income tax withholding for pass-through entity taxpayers:

- Non-business income from Utah sources net of expenses; and
- Utah business income net of expenses.

Portfolio income (interest, dividends, royalty income and similar income which is not earned in the ordinary course of a trade or business) is not part of Utah non-business income if the pass-through entity taxpayer is not required to include the portfolio income as Utah income.

Withholding Tax Rate

The Utah withholding tax rate is 5% (.05).

Withholding Due Date

Pass-through entity withholding is due on or before the return due date of the pass-through entity without regard to an extension.

Reporting Withholding to the Pass-through Entity Taxpayer

The pass-through entity must provide the partner, member or shareholder a statement showing the pass-through entity's federal identification number (EIN) and the amount of Utah pass-through entity withholding tax it reported on behalf of the partner, member or shareholder.

For 2010 and future tax periods, the pass-through entity must provide a Utah TC-20S Schedule K-1 or a TC-65 Schedule K-1 to its pass-through entity taxpayers showing the allocated Utah income and withholding amount.

Waiver of Withholding Tax

2010 and Future Tax Years

A pass-through entity (including a downstream pass-through entity) may request a waiver of the Utah withholding requirement by checking a box on TC-20S Schedule N or TC-65 Schedule N. A pass-through entity may request waiver of the withholding requirement on all or some of its partners, members or shareholders by completing the box on the applicable Schedule N and on the Utah Schedule K-1 it provides to the partner, member or shareholder.

The extension period for a partnership return is five months. Therefore, to qualify for the waiver, the entity should ensure that all downstream entities and taxpayers for whom the waiver is claimed file and pay their Utah tax due on or before the five-month extension period expires.

If a downstream entity or taxpayer for whom the waiver is claimed fails to file a return and make the required payment in a timely manner, the pass-through entity is not eligible for the waiver and **is liable** for the Utah withholding on those amounts, plus any penalties and interest.

2009 Tax Year Only

A pass-through entity (including a downstream pass-through entity) that is required to withhold Utah tax on partners, members or shareholders may request a waiver of the withholding requirement and any associated penalty and interest by submitting a request in writing to the Tax Commission if all of the following apply:

- The pass-through entity files a return by the due date, including an extension;
- The pass-through entity does not withhold or pay the Utah withholding tax;
- All pass-through entity taxpayers included in the waiver request must file their Utah return and pay the tax due on or before the due date for filing the pass-through entity taxpayer's return, including an extension; and

*See *Waiver of Withholding Tax* on this page

- The pass-through entity applies to the Tax Commission for a waiver in writing.

The waiver request must include the names and identification numbers of the pass-through entity taxpayers for whom the waiver is requested.

If all of the above conditions are not satisfied, the pass-through entity is not eligible for the waiver and **is liable** for the withholding on those amounts plus any associated penalties and interest.

▷ **Example 7:**

For tax year 2011, Partnership A has two partners, Partnerships B and C. Partnership B has two partners, both Utah resident individuals. Partnership C has three nonresident partners, all of whom are subject to Utah income tax. Partnership A has no involvement or information regarding Partnership C's nonresident partners. Partnership A's responsibility for withholding is based on Partnerships B and C. Partnership A is not directly related to the partners of Partnerships B and C. Accordingly, Partnership A must withhold tax on behalf of Partnerships B and C. However, if both Partnership B and the partners of Partnership B file returns and pay any tax due by the filing due date for Partnership A, including extensions, Partnership A may elect to not withhold those amounts and may apply to the Tax Commission, by completing the waiver request box for Partnership B on Schedule N of the tax return, for a waiver of tax, penalty and interest on the amount Partnership A should have collected and remitted for Partnership B, but did not.

▷ **Example 8:**

Partnership D is a family partnership with two resident individual partners and one partner that is a family partnership with some nonresident individual partners. The federal adjusted gross income of each of the individual partners (both the resident partners of the first tier partnership and the nonresident partners of the second tier partnership) is less than the sum of their federal personal exemption and their federal standard deduction. As a result, all the individual partners are exempt from Utah income tax under Utah Code §59-10-104.1. Partnership D is not required to withhold Utah tax for the Utah resident partners. In addition, Partnership D may apply for a waiver of withholding on the second tier partnership by checking the waiver request box on Schedule N, because no Utah tax will ultimately be due from any of the downstream taxpayers.

▷ **Example 9:**

Partnership E has two partners, Partnerships F and G. Partnership F has two nonresident individual partners and Partnership G has two partners that are professional corporations. Partnership E's CPA prepares returns for all of the partnerships including the nonresident individuals, the professional corporations and their shareholders. Consequently, Partnership E can verify that all the downstream partners, including the nonresident individual partners and the professional corporation shareholders, filed and paid Utah tax on or before Partnership E's extended return due date. Partnership E may elect to not withhold the tax and apply to the Tax Commission for waiver of tax, penalty and interest, by checking the waiver request box on Schedule N for all pass-through entity taxpayers on the tax return.

Forms

The withholding is reported on the Schedule N of the Utah partnership or S corporation return (TC-65 or TC-20S) and the face of the TC-65 and the Schedule A of the TC-20S.

The Utah withholding payment should be made using form:

- TC-544, Partnership Return Payment Coupon, when the return is filed on or before the due date of the return; or
- TC-559, Corporate/Partnership Payment Coupon, when making a prepayment on or before the return due date.

Starting with the 2010 tax year, Utah Schedules K and K-1 must be completed by each pass-through entity for each pass-through entity taxpayer.

Filing Responsibilities

If a pass-through entity taxpayer (partner, member or shareholder) has Utah withholding tax withheld by the pass-through entity on the taxpayer's behalf, and the taxpayer has no other Utah source income or Utah credits, the taxpayer is not required to file a Utah return. However, if the taxpayer has any other Utah source income or Utah credits, the taxpayer must file a return reporting such income and claiming such credits, including the credit for the withholding tax paid on the taxpayer's behalf by the pass-through entity.

Frequently Asked Questions

Q-1: Is a partnership required to withhold Utah tax if all of the ultimate downstream pass-through entity taxpayers are resident individuals?

A-1: Yes. However, the partnership may request a waiver if all of the downstream entities and taxpayers file and pay the Utah tax on or before the partnership's filing due date, including extensions.

Q-2: Is Utah withholding tax required when a pass-through entity taxpayer is a professional corporation and the professional corporation has withheld income taxes on all of its shareholders sufficient to pay the tax?

A-2: Yes. See answer to previous question.

Q-3: In the past, partnerships that have all Utah resident partners have not been required to file a Utah partnership return. Has this changed?

A-3: Yes, the rule now requires a partnership that is a pass-through entity taxpayer (a second tier partnership) to file a Utah partnership return. Therefore, a partnership that has Utah withholding tax credit from another pass-through entity must file a Utah partnership return, allocate the withholding credit to its partners, and give each partner a Utah Schedule K-1 (if 2009, a supplemental federal Schedule K-1 statement) showing the allocated withholding.

Q-4: Can a pass-through entity use credits it qualifies for to offset the withholding?

A-4: The only credits that may be taken into account in calculating the required withholding tax are the Utah mineral production withholding and Utah withholding tax by an upper tier pass-through entity. Other credits, such as the Historic Preservation Credit, along with the Utah mineral production withholding and the Utah withholding tax by an upper tier pass-through entity, must be allocated and claimed on the ultimate pass-through entity taxpayer's return.

Q-5: Is a trust or estate required to withhold Utah tax?

A-5: No, trusts and estates are not pass-through entities for purposes of Utah withholding. However, they may be pass-through entity taxpayers, so may have withholding to pass through to beneficiaries.

Q-6: How does a trust or estate handle the Utah withholding as a pass-through entity taxpayer?

A-6: For any portion of the withholding allocated or apportioned to beneficiaries, the trust or estate should allocate and pass through its Utah withholding tax credit to its beneficiaries using a Utah Schedule K-1. For 2009, the trust or estate should issue a supplemental federal Schedule K-1 statement to its beneficiaries showing the beneficiaries' withholding credit.

Q-7: Does Utah allow a composite partnership filing on Utah form TC-65 for tax year 2009 and future years?

A-7: No. Composite partnership returns are no longer an option effective for tax years beginning in 2009. They were replaced by the Utah pass-through entity withholding tax requirements.

Q-8: Is Utah withholding required when the IRS considers a partner or shareholder a disregarded entity?

A-8: It will depend on how IRS classifies the partner or shareholder for federal tax purposes. If the entity is disregarded for federal purposes, it is disregarded for pass-through entity Utah withholding tax purposes. For example, if the pass-through entity taxpayer is a single member LLC and when disregarded is treated as an individual Utah resident, then no Utah withholding is required. However, if the single member LLC when disregarded is treated as a nonresident individual or a corporation, withholding is required unless one of the exceptions applies.

Q-9: How does a pass-through entity report the Utah withholding tax to its partners, members or shareholders?

A-9: For 2010 and future returns, the pass-through entity should complete the Utah Schedule K-1 showing the withholding for each partner, member or shareholder.

For 2009, the pass-through entity should issue a supplemental federal Schedule K-1 statement to its partners, members or shareholders showing the respective Utah withholding tax amount.

Q-10: When is the Utah withholding tax due?

A-10: The Utah withholding tax payment is due on the pass-through entity's return due date, without regard to any extension. If the pass-through entity will be filing its return under extension, it should use form, TC-559, *Corporate/Partnership Payment Coupon,* to make the withholding payment by the return due date.

Q-11: Are interest and penalties charged on late Utah withholding tax payments?

A-11: Interest is charged on the unpaid amount from the return due date to the date paid. Penalties may also be charged for failure to pay the required extension payment amount, for filing the return late and for paying late. See Publication 58, *Utah Interest and Penalties,* for detailed information on penalties and interest.

Q-12: What happens if the pass-through entity does not withhold the tax?

A-12: The pass-through entity is required to withhold, pay and report the tax, unless one of the exceptions applies or it qualifies for a waiver. If the pass-through entity does not withhold the tax and does not qualify for waiver or any of the exceptions, the Tax Commission will assess and collect the withholding amount and any penalties and interest from the pass-through entity.

Definitions

Business Income

Income from transactions and activity arising in the regular course of the entity's trade or business. It includes income from tangible and intangible property if the acquisition, management and disposition of the property are an integral part of the entity's regular trade or business operation.

Downstream Pass-through Entity Taxpayer

A pass-through entity taxpayer that is a pass-through entity taxpayer of any entity that is itself a pass-through entity taxpayer. The first pass-through entity is the first tier entity, its pass-through entity taxpayers are second tier entities, any pass-through entity taxpayers of the second tier entities are third tier entities and so on.

Nonbusiness Income from Utah Sources

All income that is not business income and that is derived from or connected with Utah sources. It does not include portfolio income if the income would not be reportable to Utah on a pass-through entity taxpayer's Utah income tax return or the Utah income tax return of any downstream pass-through entity taxpayer.

Pass-through Entity

An entity whose income, gains, losses, deductions and credits flow through to partners, members and shareholders for federal tax purposes. For purposes of Utah withholding tax, pass-through entities include:

- General partnerships, limited partnerships, limited liability partnerships;
- Limited liability companies if classified as a partnership for federal income tax purposes; and
- S corporations.

A pass-through entity does not include an estate or trust.

Pass-through Entity Taxpayers Subject to Utah Withholding Tax

- Nonresident individual partners, members and shareholders; and
- Resident and nonresident general partnerships, limited partnerships, limited liability partnerships, limited liability companies, S corporations, C corporations, and estates and trusts.

Portfolio Income

For purposes of pass-through entities, portfolio income usually includes all gross income, **other than income derived in the ordinary course of a trade or business** and **Utah nonbusiness income taxable on the Utah return of a pass-through entity taxpayer**.

Portfolio income includes:

- interest;
- dividends;
- royalties;
- income from the disposition of property that produces income of a type defined as portfolio income;
- income from the disposition of property held for investment; and
- income from a real estate investment trust, a regulated investment company, a real estate mortgage investment conduit, a common trust fund, a controlled foreign corporation, a qualified electing fund, or a cooperative.

Interest, dividends, royalties, etc., earned in the ordinary course of the trade or business of a pass-through entity are **not** portfolio income.

▷ **Example 10:**

Interest and dividends may be considered portfolio income if the pass-through entity had funds that were not used to further the trade or business and were invested and generated interest or dividends. Interest and dividends are not considered portfolio income if the entity's primary business activity is investing funds, such as with a brokerage firm.

Portfolio income is attributable to the resident state.

Utah Source Income

- For a C corporation, income derived from or connected with Utah sources per Utah Code §59-7, Part 3.
- For a partnership, S corporation, estate, trust, or individual, income derived from or connected with Utah sources per Utah Code §§59-10-117 and 59-10-118.