

# ADVISORY

## SULLIVAN & WORCESTER LLP TAX ADVISORY

### Massachusetts to Require Withholding by "Pass-Through Entities," Effective January 1, 2009

In 2004, the Massachusetts personal income tax withholding statute was amended to include a provision giving the Massachusetts Department of Revenue ("DOR") authority to require "persons other than employers" to deduct and withhold taxes from payments made to residents and nonresidents. DOR suggested at the time that the amendment was intended to permit it to require withholding by persons making payments to athletes and entertainers who perform in the Commonwealth, and indeed the provision has been so used. TIR 04-25 (Oct. 26, 2004). Draft regulations indicate, however, that DOR plans to exercise broader authority and require withholding by pass-through entities ("PTEs" -- that is, partnerships, limited liability companies, Subchapter S corporations and certain estates) that have a presence in the Commonwealth and have nonresident owners. At the same time, DOR proposes to liberalize the rules for composite returns filed on behalf of nonresident owners.

The new rules are included in working drafts of (1) an amendment to the composite return portion of the nonresident income tax regulation, 830 Mass. Code Regs. 62.5A.1; and (2) a new regulation on withholding by PTEs, 830 Mass. Code Regs. 62B.2.2.

#### COMPOSITE RETURNS

The amendment to the composite return regulation would permit a PTE to file a composite return even if its nonresident owners have Massachusetts income from sources other than the PTE, provided the nonresident files a separate return for the other Massachusetts source income. Currently, nonresidents must have no Massachusetts source income other than income from the PTE to participate in a composite return.

The amended regulation would also permit participating members to claim deductions, exemptions and credits on their separate returns. Under existing rules participating members must forgo deductions, exemptions and credits as a condition of inclusion in the composite return.

In one respect, however, the draft regulation would discourage participation in a composite return. DOR proposes not to treat a composite return as an individual return for purposes of the statute of limitations for assessments. In theory, then, the period for

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assessing additional tax would appear to remain open indefinitely with respect to the income of PTEs filing a composite return. (See, however, the discussion of voluntary disclosure agreements below.)

## **PTE WITHHOLDING**

### **– In general**

The new withholding regulation would require PTEs that maintain offices or engage in business in Massachusetts to deduct and withhold Massachusetts tax from “distributive shares” allocated to nonresident members, unless an exemption applies. While the draft regulation sheds little light on how such distributive shares will be calculated, it does appear clear that Massachusetts intends to follow the majority of states with PTE withholding in basing the withholding on the anticipated income of the PTE, rather than on the distributions that it makes to members. The exemptions from withholding would operate as follows.

First, a PTE would be exempt from the withholding rules if it qualifies as either (1) an investment partnership or (2) an upper-tier PTE of a tiered structure that can demonstrate that a lower-tier PTE has already withheld all of the tax on income that would otherwise be subject to withholding by the upper-tier PTE.

An “investment partnership” is a partnership or LLC meeting three criteria: (1) substantially all of the entity’s assets consist of investment securities, deposits at banks or other financial institutions, or office equipment and office space reasonably necessary to carry on the activities of an investment partnership; (2) substantially all of the entity’s income is from interest, dividends and capital gains; and (3) the entity is not engaged in a trade or business in Massachusetts. This definition would require some investment partnerships to withhold even though their nonresident owners would not have to pay Massachusetts tax. Under Massachusetts General Laws c. 62, §17, a nonresident partner in a partnership that neither conducts a trade or business nor owns or leases Massachusetts real estate is not subject to Massachusetts tax on its distributive share of partnership income. Nevertheless, such a partnership would be required to withhold if it failed either the asset or the income test for qualification as an investment

partnership. Presumably the nonresident partners in such a partnership would be permitted to file individual returns to obtain a refund of tax withheld by the partnership.

A separate section of the new regulation would apply to tiered entities. The new regulation would require upper-tier PTEs to withhold tax with respect to the income of nonresident members if they cannot demonstrate that a lower-tier PTE has already withheld the tax.

Second, PTEs would be exempt from withholding tax on a member’s distributive share of income if the member is itself exempt. The following classes of members are exempt: (a) federally tax-exempt members; (b) Massachusetts residents that are individuals, estates, or trusts, or that are corporate trusts engaged in the Commonwealth in any business, activity, or transaction; (c) corporations that are subject to Massachusetts corporate tax laws and are filing a return, or PTEs that have a usual place of business in Massachusetts; and (d) nonresidents who either (i) participate in composite returns filed by the PTE or (ii) file a certification with the PTE stating that they agree to file tax returns, make quarterly estimated tax payments, and accept personal jurisdiction in Massachusetts state courts for the determination and collection of taxes, including estimated tax payments, and related interest, penalties, and fees imposed with respect to the income of the PTE. This certification “opt-out” provision is a feature that is not always available in states that require PTE withholding. It could be especially attractive to a member whose Massachusetts activities unrelated to the PTE may ameliorate the tax impact of the PTE activities in the Commonwealth.

Notwithstanding the exemptions from withholding, if any PTE member, including any resident member, fails to meet its filing obligations in a timely fashion, the PTE would be required to withhold and make tax payments on the member’s behalf prospectively, upon notification by the Commissioner. In addition, PTEs required to withhold would be considered jointly and severally liable with each non-exempt member for all taxes, together with related interest and penalties, imposed on the member by Massachusetts with respect to income of the PTE. Any PTE that failed to meet its withholding obligation would be subject to all applicable penalties for failure to withhold under the withholding statutes.

It is not clear that the Massachusetts statutes authorize the imposition of tax, interest and penalties on PTEs. The provisions of the withholding statute that provide for such "trustee" liability apply by their terms to "employers" as defined under the Internal Revenue Code. G.L. c. 62B, § 1; see I.R.C. § 3401(d). PTEs, on the other hand, are required to withhold as "persons other than employers." G.L. c. 62B, § 2.

#### – PTE payments

The new regulation would require PTEs to make their required annual payments in four installments calculated by multiplying the withholding rate (typically 5.3% for individuals) by the lesser of 80% of the member's distributive share for the taxable year, or 100% of the member's prior year distributive share. Although this provision mirrors the estimated payment safe harbor for individuals, PTE members could nevertheless be subject to estimated tax penalties even if the member and the PTE pay in the ostensible safe harbor amounts set forth for each of them independently.

Suppose, for instance, that a nonresident member ("M") owns 50% of "a PTE," which does business exclusively in Massachusetts. In 2009, M's tax liability in Massachusetts is \$10,000, apart from the income of the PTE. In 2010, M's tax liability so computed is \$3,000. In 2009, the PTE has Massachusetts source income of \$100,000 and in 2010 it increases to \$400,000. Taking into account the tax on M's 50% distributive share of the PTE's Massachusetts source income, M's total liability is \$12,650 in 2009 and \$13,600 in 2010. Even if M pays in 100% (as opposed to the required 80%) of his 2010 tax liability without regard to the income of the PTE (\$3,000), if the PTE covers the safe harbor by paying 100% of the tax with respect to his previous year's distributive share (\$2,650), then the total amount paid by and on behalf of M will be only \$5,650:

	Non-PTE	50% PTE	Total
2009 Tax Liability	\$10,000	\$2,650	\$12,650
2010 Tax Liability	\$3,000	\$10,600	\$13,600
Estimated Tax Payment	\$3,000	\$2,650	\$5,650

However, in order to meet the safe harbor, the tax paid must equal the lesser of \$12,650 or \$10,880

(80% of the combined 2010 liability of \$13,600). Thus, it appears that under the rule in the working draft regulation, M could be subject to an estimated tax penalty for 2010.

This problem could be cured by the adoption of a rule that if the PTE satisfies its estimated tax/withholding obligations, the member will not be required to take into account the PTE income in determining whether the member is subject to estimated tax penalties.

To satisfy its withholding obligation, the PTE would have to make four installment payments toward the required annual payment on behalf of each member for the taxable year in an amount equal to 25% of the required annual payment. The installments would be due by the last day of the month following the close of the calendar quarter. This due date could potentially subject members, who themselves are required to file estimates by April 15, June 15, September 15 and January 15, to estimated tax penalties because of the lag between the individual estimated tax and PTE withholding due dates.

#### – What is Massachusetts-source income of a PTE that is subject to withholding?

The new regulation would define Massachusetts-source income as Massachusetts gross income derived from or effectively connected with (1) any trade or business, including any employment, carried on by a PTE entity in Massachusetts, whether or not the entity is actively engaged in a trade or business or employment in Massachusetts in the year in which the income is received; (2) the participation in any lottery or wagering transaction in Massachusetts; or (3) the ownership of any interest in real or tangible personal property located in Massachusetts. This definition mimics the statutory definition of income taxable to a nonresident, but on its face it could be said to be inconsistent with the sourcing rules for PTEs set forth in the regulations. 830 Mass. Code Regs. 62.5A.1. These rules require a PTE having income that is taxable both within and without Massachusetts to report a member's apportioned share of income to the member using the corporate apportionment rules. See 830 Mass. Code Regs. 63.38.1.

#### – Implications of the new rules for PTEs and their members

The proposed adoption of PTE withholding rules in Massachusetts is part of a multistate pattern of adopting such rules over the last decade or so. Unfortunately, PTE withholding is yet another area of state tax law that is neither simple nor uniform. Massachusetts's adoption of a PTE withholding regime will add to the compliance challenges for PTEs, especially those with many partners in many states.

The threat of penalties for failure to follow the withholding rules may call for a review of S corporation, partnership and LLC agreements to ensure that the impact of the new rules on members is equitable.

The proposed rules can also be expected to lead to greater compliance by nonresident members of PTEs, and in anticipation of their adoption, nonresident members who have not filed in the past may seek to come into compliance for earlier years.

For such members, the voluntary disclosure program that Massachusetts has adopted may alleviate those concerns. Under the voluntary disclosure rules, the DOR will generally limit assessments to the three most recent tax years in cases in which nonresident individual taxpayers and foreign corporations voluntarily disclose their non-filing pursuant to a "voluntary disclosure agreement" or "VDA." Mass. TIR 03-17. This is an exception to the general rule that permits the Commissioner to assess a non-filing taxpayer with respect to returns due during the most recent seven years. *Id.* For taxpayers participating in the VDA program, the DOR typically will waive any penalties that may otherwise be imposed.

Under the VDA program, taxpayers may secure a tentative DOR agreement to a three-year look-back on an anonymous basis by having their tax advisors outline their circumstances in writing to the DOR without naming them. Sullivan & Worcester's state tax attorneys are well versed in the VDA rules and are able to assist clients who wish to come into compliance in anticipation of adoption of the PTE withholding regulation.