

## Revamped State Regulation Addresses Withholdings on Distributions to Nonresident Members of Pass-Through Entities

BY RICHARD C. LITWIN, ESQ.  
RICHARD C. LITWIN, L.L.C.

In an effort to ensure that nonresidents file returns and pay their share of income tax, the State of Georgia imposes a 4% withholdings tax at the entity level on distributions to nonresident members of any partnership, Subchapter S corporation, or limited liability company (hereinafter singularly “Entity” and collectively “Entities”). The withholding rules mirror those imposed on wages paid by an employer to an employee: the withholding must be remitted to the Department of Revenue (the “Department”) and several reports must be prepared and filed with the Department and sent to the nonresident members.

The withholding statute has been effective for over 10 years. Still, the statutory requirement remains a mystery to many Entities. Those aware of the withholding obligations struggle to grasp the amount on which to withhold and when to withhold such amount and remit it to the Department.

New Regulation: In late 2005, the Department repealed the regulation addressing the withholding requirements and replaced the regulation with a more comprehensive version. The new regulation clarifies areas that have stymied Entities in the past. The new regulation, Ga. Reg. 560-7-8-.34, can be found at <http://rules.sos.state.ga.us/docs/560/7/8/34.pdf>. It applies to tax years beginning on or after January 1, 2006. The old version of the regulation applies to tax years that begin prior to January 1, 2006. This article provides an overview of the statutory obligation and discusses key provisions of the new regulation.

Background - Imposition of Withholdings: Any Entity that owns property or conducts business in Georgia is subject to a withholding tax. Official Code of Georgia Annotated (“O.C.G.A.”) § 48-7-129(a).<sup>1</sup> The tax is not limited to Georgia-based Entities. Non-Georgia Entities (foreign corporations or LLC’s or partnerships formed outside Georgia) doing business in Georgia also have withholding duties.<sup>2</sup>

The tax is withheld from “distributions paid or credited” to members who are not residents of Georgia. O.C.G.A. § 48-7-129(a). A “member” includes a partner, shareholder, or other person to whom the taxpaying obligation of the partnership, S corporation or limited liability company

---

<sup>1</sup> Effective April 9, 1993 and with respect to any distribution paid or credited after January 1, 1994.

<sup>2</sup> “Doing business in this state” includes having an office or other facility, performing services or having employees who maintain an office or who regularly solicit business in Georgia. See O.C.G.A. § 48-7-100(3)(A) for the complete definition.

falls. O.C.G.A. § 48-7-100(6.1).

Identifying Nonresident Members: A “nonresident” is an individual or fiduciary member who resides outside Georgia and all other members whose headquarters or principal place of business is locate outside Georgia. O.C.G.A. § 48-7-100(6.2). It includes a “taxable nonresident.” O.C.G.A. § 48-7-1(6). A “taxable nonresident” is an individual who is not otherwise a resident of Georgia for income tax purposes and who regularly, not casually or intermittently, engages within Georgia, by himself or herself or by means of employees, agents, or partners, in employment, trade, business, professional, or other activity for financial gain or profit including, but not limited to, the rental of real or personal property located within this state or for use within this state. O.C.G.A. § 48-7-1(11)(A).<sup>3</sup>

Understanding the New Definition of Distributions Paid or Credited: The Department insists that the amount on which the Entity must withhold, “distributions paid or credited,” means the nonresident member’s “distributive share.” This position creates much confusion for Entities and their advisors.

The Georgia Revenue Code defines “distributions paid or credited,” and the words “distributive share” are not included in the definition. The Georgia General Assembly uses the term “distributive share” in other provisions of the Georgia Revenue Code. *E.g.* O.C.G.A. § 48-7-24. The new regulation is aimed at clarifying the confusion, certainly as to the Department’s stance that “distributions paid or credited” *includes* the member’s schedule K-1 income. Indeed, under the new regulation, an Entity must “withhold” on the nonresident partner, member or shareholder’s distributive share of income, even where the Entity makes no cash distribution to its members. *See* Ga. Reg. 560-7-8-.34(1)(a) and (2)(a). As a result, an Entity can be assessed back taxes, penalties and interest, for failing to withhold.

“Distributions paid or credited,” the amount on which an Entity must withhold 4%, is defined in the Georgia Revenue Code as a disbursement of funds or recognition or assignment of interest in proceeds or property of an Entity, which is passed through to the members and which may be subject to Georgia income tax. *See* O.C.G.A. § 48-7-100(2.1). Under the new regulation, “distributions paid or credited” includes a cash payment, a distribution of other property, a credit to the member in lieu of such payment, or the member’s distributive share of the Entity’s income or other gain that is passed through to the member and which is subject to Georgia income tax. Ga. Reg. 560-7-8-.34(1)(a). Thus, the Entity must withhold and pay 4%, even where the Entity has no cash to make such payment. The Department will waive the withholding requirement in situations where the Entity qualifies for “undue hardship.” However, lack of

---

<sup>3</sup> For tax years beginning on or after January 1, 2005, “taxable nonresident” does not include a legal resident of another state whose only activity for financial gain or profit in this state consists of performing services in this state for an employer as an employee when the remuneration for the services does not exceed the lesser of 5 percent of the income received by the person for performing services in all places during any taxable year or \$5,000.00. O.C.G.A. § 48-7-1(11)(A).

funds to pay the 4% withholding is not “undue hardship.” Ga. Reg. 560-7-8-.34(6).

Member’s Payment of Estimated Taxes does not Excuse Withholding: A member may instruct the Entity not to withhold where the member pays estimated taxes to the Department. Under the new regulation, however, payment of estimated taxes by the member does not excuse the Entity from remitting the 4% withholding. Ga. Reg. 560-7-8-.34(2)(a).

Catch Up Provisions: The new regulation addresses confusion when cash payments differ from the member’s distributive share of income. Under the new regulation, withholding is required on the pass through of the Entity’s income to the member. The amount on which withholding is required is reduced by distributions paid or credited throughout the year *if withholding has already occurred* on such distributions. Ga. Reg. 560-7-8-.34(2)(a)4. Further, under the new regulation, distributions paid or credited are first considered to be distributed from the member’s current year distributive share. In that regard, distributions paid or credited that exceed the member’s distributive share are not subject to withholding. Ga. Reg. 560-7-8-.34(2)(d). The Department’s effort to clarify the elusive tax base, nevertheless, does not address whether the Entity should withhold on “cash distributions” or on “distributive share.” Thus, where an Entity makes “cash distributions” during the year and no withholdings have been paid on such payments, the Entity should withhold on the payments to nonresident members.

Distributions to Exempt Organizations and Insurance Companies: A member of an Entity may direct that the Entity not withhold due to the member’s tax-exempt status. The Department recognizes that some situations lend themselves to excusing the withholding rule. Under the new regulation, an Entity is not required to withhold on a distribution paid or credited to an exempt organization, unless the distribution paid or credited will result in unrelated business taxable income (“UBTI”), under I.R.C. § 512. Ga. Reg. 560-7-8-.34(2)(e). Nor is an entity required to withhold on distributions paid or credited to an insurance company that pays tax on its premium income.

Each year, the Entity must obtain from the exempt organization or the insurance company written certification that the distribution paid or credited is not subject to withholding. The Entity must attach such certification to the Entity’s return. Ga. Reg. 560-7-8-.34(2)(e),(f).

Distributions to Corporate Members: Under the new regulation, distributions paid or credited to qualifying corporations are not subject to withholding. Ga. Reg. 560-7-8-.34(2)(g). Three conditions must be met. First, the corporation must otherwise own property or do business in Georgia.<sup>4</sup> Ga. Reg. 560-7-8-.34(2)(g)1. Second, the corporation must have filed income tax returns in Georgia for the two tax years immediately preceding the tax year in question and have paid all tax liabilities that have been assessed and are currently due. Ga. Reg.

---

<sup>4</sup> See O.C.G.A. § 48-7-100(3) for definition of “doing business in this state.”

560-7-8-.34(2)(g)2. Third, the corporation must make estimated income tax payments, if required. Ga. Reg. 560-7-8-.34(2)(g)3. A qualifying corporation must also provide to the Entity written certification that all three conditions are met, and the Entity must attach the certification to its income tax return. Ga. Reg. 560-7-8-.34(2)(g). As of March 31, 2006, the Department is developing a form on which to provide the certification.

Tiered Situations: The new regulation addresses scenarios where a nonresident member receives distributions paid or credited from more than one Entity or where a nonresident member has other nonresident members on which it must withhold on distributions paid or credited. These “tiered” situations can become confusing and the regulations seek to clarify the confusion.

In particular, where distributions are paid by one Entity to a member that is another Entity, which in turn pays distributions to another Entity, withholding is required by the Entity (1) that does business in Georgia on its own and not because it is a member of an Entity that does business in Georgia or (2) owns property in Georgia on its own and not because it is a member of an Entity that owns property in Georgia. Ga. Reg. 560-7-8-.34(4)(a). Other rules apply where withholding is passed through to the next level of the tier and such must be documented to the Department. *See* Ga. Reg. 560-7-8-.34(4)(b).

The regulation also addresses nonresident members who are members of more than one Entity. Under the regulation, a nonresident member may not offset loss expected from one Entity against income expected from another Entity in order to avoid the withholding imposed on the Entity that has income for the year. Ga. Reg. 560-7-8-.34(4)(d)1.

Penalties for Failure to Withhold: Understanding the withholding rules is critical because of the stiff penalties imposed for failing to withhold. Under the statute, the penalty for failing to withhold is 100% of the tax. *See* O.C.G.A. § 48-7-129(a)(3). Thus, where the withholding tax totals \$50,000.00 and the Entity fails to withhold, the Entity is liable for tax of \$50,000.00, penalty of \$50,000.00 and any accrued interest. Moreover, the Department can assess each member, because the liability is joint and several. *See* O.C.G.A. § 48-7-129(a)(4).

Arguing that the nonresident members filed nonresident income tax returns and paid tax for the year at issue will not absolve the Entity from liability for the tax, interest and penalty. In this regard, Entities affected by the withholding rules should review the regulations carefully to ensure compliance.

Conclusion: The withholding obligations affect many types of Entities, including real estate partnerships, family partnerships, and professional firms, such as law firms and accounting firms that have nonresident members. Careful consideration must be given to the rules and the penalties to ensure proper compliance.