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IDAHO ENACTS COMPLEX WITHHOLDING AND ELECTION RULES FOR PASS-THROUGHS

Dennis Rimkunas
New York
1.212.326.3412
drimkunas@jonesday.com

Carolyn Lee
New York
1.212.326.3966
cjlee@jonesday.com

The majority of states and localities, including Idaho, conform to the federal income tax treatment of partnerships, and treat them as conduits, with the income flowing through to the partners, and with the ultimate tax obligation imposed on the partners. The notable exceptions to this rule are Michigan, New Hampshire, Ohio, Tennessee, Texas, and New York City, which impose taxes directly on the entity.

Historically, states that allow flow-through of income have faced compliance and collection problems, when the in-state partnership would distribute income to nonresident partners, who otherwise have limited connections to the taxing state. To combat this noncompliance, many states have now enacted provisions that effectively require the in-state partnerships to pay their partners' taxes. Typically, states require partnerships either to withhold tax out of distributions made to partners, or to make estimated tax payments in respect of the partners.

Effective January 1, 2011, Idaho will require pass-through entities, which include, partnerships, LLCs taxed as partnerships, S corporations, and certain trusts,[1] to withhold tax in respect of individuals "on any actual distributions of funds from income . . . ."[2] The relevant "income" is defined as:

> (a) Wages, salary and other compensation paid by the pass-through entity to such officers, directors, owners of an interest in a pass-through entity or beneficiaries to the extent the compensation is Idaho taxable income of the individual to whom it is paid; and

[1] Idaho Code § 63-3006C.

[2] Idaho Code § 63-3036B(2).

> (b) The share of any income, loss, deduction or credit of a pass-through entity required to be included on such individual's Idaho return.[3]

The withholding obligation is applicable only to distributions made to nonresident individuals.[4] The distributions will be taxed at the highest marginal individual tax rate.[5]

Alternatively, the nonresident individual may elect to have the pass-through entity itself report and pay the tax relating to the "income," defined above.[6] The election is made annually and, once made, is irrevocable for the taxable year.[7] The income would be taxed at the corporate rates.[8]

Although this election seems innocuous at first glance; it is somewhat analogous to composite return statutes in other states, and there are a number of issues that nonresident individuals and pass-throughs should be aware of. Obviously, the differential between the corporate and individual effective tax rates should be considered in making the election.

More importantly, however, although the pass-through's withholding obligation applies only to "actual distributions,"[9] no such limitation exists in the context of the pass-through paying the tax pursuant to the election.[10] Multiple instances exist where income tax may be imposed even though no actual distribution is made. Cancellation of indebtedness income, for example, or gain on a foreclosure, can create significant income but no cash. Other problems might arise in the context of "deemed distributions" resulting from a reduction of pass-through's liabilities.

Thus, it is possible that by making the election, the nonresident individual would subject the pass-through to paying more taxes than it would otherwise be responsible for if it only had to withhold out of "actual distributions of funds." If the nonresident individual's taxes are paid by the pass-through in these circumstances, the individual may effectively enjoy a cash-flow benefit that his/her co-partners (*i.e.* in-state residents) would not.

Another issue arises when the nonresident individual cannot pay his/her taxes. Because the election is strictly the individual's choice, a pass-through cannot elect out of it, and is, therefore, bound by the election. At least in the context of withholding, the pass-through pays the tax out of the cash owed to the individual. When the individual elects that the pass-through pay the taxes, the pass-through has to pay out of pocket, and then recover the cash outlay from

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[3] Idaho Code § 63-3022L(2).

[4] Idaho Code § 63-3036B(2).

[5] Id.

[6] Idaho Code § 63-3036B(3)(b); Idaho Code § 63-3022L(1).

[7] Idaho Code § 63-3022L(3).

[8] Idaho Code § 63-3022L(1).

[9] Idaho Code § 63-3036B(2).

[10] Idaho Code § 63-3022L(1).

the individual. As a result, the election, and the pass-through's obligation to make payments in respect of nonresident individuals, can create real business issues.

Ideally, these issues should be addressed in the partnership agreement. If tax payments exceed distributions that otherwise would be made, those payments should be treated as loans to the targeted partners, to be repaid to the partnership, with interest. If partners contemplate receiving periodic "tax distributions" in any event, those distributions obviously should be calculated by taking into account the taxes that might be required to be paid on behalf of such individuals.

These Idaho rules are new, and no regulations or instructions have yet been issued by the Idaho Tax Commission. Taxpayers would be remiss, however, if they do not consider the potential impact of the new Idaho legislation on their businesses, and adequately protect themselves. And unfortunately, the issues such provisions create are not unique to Idaho.

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