

# Passthrough entity withholding and composite filing for the 2006 tax year

Issued: December 4, 2006

## Purpose

This replaces the update issued August 29, 2006. This update provides information on the new withholding requirement imposed on passthrough entities and changes made to the composite filing method by the 2005 North Dakota Legislature.

## Background

The 2005 North Dakota Legislature enacted legislation requiring a passthrough entity to withhold income tax at the highest individual income tax rate from the year-end distributive share of income of its individual owners or beneficiaries who are nonresidents of North Dakota. That rate is currently 5.54%. This new requirement applies to a partnership, S corporation, trust, or a limited liability company treated like a partnership. It does not apply to a publicly traded partnership as defined under Internal Revenue Code § 7704(b) that files a partnership return.

The new withholding requirement *does not* apply to a distributive share of North Dakota income of a nonresident individual owner or beneficiary if:

- The owner's or beneficiary's distributive share of North Dakota income for the taxable year is less than \$1,000, or
- In lieu of filing his or her own North Dakota individual income tax return, the nonresident individual owner or beneficiary agrees to be included in a composite individual income tax return filed by the passthrough entity.

[[Senate Bill 2045](#); S.L. 2005, chapter 563; amending N.D.C.C. § 57-38-31.1]

## Does this new requirement apply to a passthrough entity's 2005 taxable year?

No. Although the legislation provides that the new requirement applies to taxable years beginning after December 31, 2004, the tax commissioner determined that the timing of the legislation's enactment and the constitutionally-defined effective date of August 1, 2005, would create a burden for passthrough entities to meet the new requirement with respect to their taxable years beginning in 2005.

### **When will this new requirement be applied?**

The new income tax withholding requirement will apply to taxable years beginning on or after January 1, 2006. As a practical matter, this means that the first reporting and payment of withheld income tax will not be required until the end of a passthrough entity's 2006 taxable year—see the next question and answer for more information.

### **How will the passthrough entity report and pay the withholding?**

The new passthrough entity withholding procedures have been integrated into the 2006 partnership return (Form 58), S corporation return (Form 60), and fiduciary return (Form 38). The income tax required to be withheld on the distributive shares of North Dakota income must be calculated and reported on the applicable return, and the payment of the withheld income tax must be submitted with the return when it is filed by the passthrough entity. The revisions to the passthrough entity returns for 2006 include a new North Dakota Schedule K-1. The income tax withheld by the passthrough entity must be reported to the nonresident individual owner or beneficiary on this new schedule.

### **How does the nonresident owner or beneficiary claim the withholding on his or her North Dakota individual income tax return?**

The nonresident individual owner or beneficiary claims the withheld income tax by entering it on the income tax withholding line of his or her North Dakota individual income tax return. This is the same line on which income tax withheld reported on a Form W-2 or Form 1099 is entered on the return. A copy of the North Dakota Schedule K-1 must be attached to the return to support the claimed income tax withheld. If the return is electronically filed, the Schedule K-1 must be retained by the taxpayer, preparer, or electronic return originator in the same manner as a Form W-2 or 1099.

### **What is a composite return?**

An alternative filing method, called the "composite filing method," has been allowed under North Dakota income tax law since 1995. The 2005 North Dakota Legislature changed the composite filing method law as part of the same legislation that created the new passthrough withholding requirement. The changes included extending the composite filing privilege to trusts having nonresident individual beneficiaries and making the use of the composite filing method an exception to the new passthrough withholding requirement.

Under the composite filing method, a passthrough entity files one return, called a "composite return," on behalf of one or more eligible nonresident individual owners or beneficiaries. To be eligible, a nonresident individual owner or beneficiary must not have any North Dakota income from other than one or more passthrough entities doing business in North Dakota. The filing of a composite return and the payment of the income tax calculated on it satisfies the North Dakota income tax filing and payment obligations of the eligible nonresident individual owners or beneficiaries included in it. This means that the nonresident individual owners or beneficiaries

who agree to be included in the composite return do not have to file a separate North Dakota income tax return on their own behalf to report or pay tax on their respective distributive share of North Dakota income. The use of the composite filing method by a passthrough entity is optional, and is a choice that may be made on a year-to-year basis. The passthrough entity does not have to obtain prior approval to use the composite filing method.

The distributive share of North Dakota income of a nonresident individual owner or beneficiary included in a composite return is multiplied by the highest individual income tax rate. For the 2006 tax year this rate is 5.54 percent. The resulting tax (referred to as the "composite tax") is the North Dakota income tax liability of the nonresident individual owner or beneficiary for the year. No adjustments, deductions, or tax credits that are otherwise allowable on a North Dakota individual income tax return are allowed under the composite filing method.

Starting with the 2006 taxable year, the composite tax calculation and filing procedures have been integrated into the 2006 partnership return (Form 58), S corporation return (Form 60), and fiduciary return (Form 38).. The passthrough entity will submit payment of the total composite income tax with its income tax return when it is filed.

### **How can the passthrough entity withholding requirement be avoided through the filing of a composite return?**

If an eligible nonresident individual owner or beneficiary who agrees to have his or her distributive share of North Dakota income included in a composite filing by the passthrough entity, the passthrough entity is not required to withhold income tax from that individual's distributive share of North Dakota income. Therefore, if all of the eligible nonresident individual owners or beneficiaries agree to be included in a composite return, the passthrough entity does not have to withhold income tax from any of its owners' or beneficiaries' distributive shares of North Dakota income.

### **Are the 2006 Form 38, 58, and 60 available for review?**

The 2006 version of Forms 38, 58, and 60 will be finalized soon. They will be placed in their own booklets for the first time. It is anticipated that the forms and their instructions will be available on our web site sometime the week of December 11 through 15, 2006. Check for them under "Tax Professionals" on our web site at [www.nd.gov/tax](http://www.nd.gov/tax).