RULE 2006-3: "INCOME TAX RULE WITHHOLDING ON NONRESIDENT MEMBERS OF PASS-THROUGH ENTITIES"

This rule is adopted under the provisions of *Ark. Code Ann.* §§ 25-15-204, 26-18-101 et seq., 26-51-101 et seq. and 26-51-919(e). This rule is necessary to properly administer the withholding provisions of Ark. Code Ann. § 26-51-919 with regard to the taxable income of nonresident members of pass-through business entities.

A. General provisions: Except as provided in Section E, any pass-through entity that makes a distribution to a non-resident member is required to deduct and withhold Arkansas income tax from distributions of taxable income being made with respect to Arkansas source income.

B. Definitions: The following words and terms, when used in this Rule, shall have the following meanings:
   1. "Department" means the Arkansas Department of Finance & Administration.
   2. "Distributed" or "Distribution" means a non-resident member's distributive share of a pass-through entity's income and shall include 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 Arkansas income tax. Distributions paid or credited are not subject to withholding under Ark. Code Ann. § 26-51-919 if the distributions paid or credited to the non-resident members are subject to withholding under other provisions of Arkansas law, or represent a return of such member's investment, or a return of capital, or represent previously taxed income. If distributions are subject to withholding under other provisions of Arkansas law, distributions paid or credited are first considered to be distributed out of a member's current year distributive share of an entity's income or other gain that is passed through to the member and which is subject to Arkansas income tax. Any distributions paid or credited for the year that exceed the member's distributive share of the entity's income or other gain that is passed through to the member are not subject to Arkansas withholding.
   3. "Member" means:
      a. A shareholder of an S-Corporation;
      b. A partner in a general partnership;
      c. A partner in a limited partnership;
      d. A partner in a limited liability partnership;
      e. A member of a limited liability company; or
      f. A beneficiary of a trust.
   4. "Non-resident" means:
      a. an individual who is not a resident of, or domiciled in, Arkansas during any part of the tax year;
      b. a business entity which does not have a commercial domicile in Arkansas during any part of the tax year; or

c. a trust that is not organized in Arkansas.

5. "Pass-through entity" means:
   a. A corporation that is treated as an S-Corporation under the *Internal Revenue Code*;
   b. A general partnership;
   c. A limited partnership;
   d. A limited liability partnership;
   e. A trust;
   f. A limited liability company; or
   g. A pass-through entity does not include any entity listed in (a) through (f) that is taxed as a corporation or is a disregarded entity for federal income tax purposes.

C. Withholding rate:
   1. Corporations, partnerships and LLC's: In the case of S-Corporations, general, limited, or limited liability partnerships and limited liability companies, withholding at the highest income tax rate levied under §§ 26-51-201 and 26-51-202 is required on the Arkansas portion of the taxable income distributed to each non-resident member. In the case of S-Corporations paying the tax on behalf of non-resident shareholders or partnerships filing composite returns on behalf of non-resident partners, the non-resident members' withholding can be claimed on the return filed by the S-Corporation or the partnership.
   2. Trusts: With regard to trusts, withholding at the highest income tax rate levied under §§ 26-51-201 and 26-51-202 is required on the Arkansas portion of the taxable income distributed to each non-resident beneficiary of the trust.

D. Members not subject to withholding: The following persons and organizations are not subject to withholding by a pass-through entity:
   1. Non-resident members whose income has been determined by the Department not to be subject to withholding;
   2. Non-resident members whose income is exempt from Arkansas income tax under § 26-51-202(e);
   3. Non-resident members who have a pro rata or distributive share of income of the pass-through entity from doing business in or deriving income from sources within Arkansas of less than $1,000 per year;
   4. Non-resident members who elect to have the tax due paid as part of a composite return (Form AR1000CR) filed by the pass-through entity under § 26-51-919(d);
   5. Organizations granted an exemption under Section 501(c)(3) of the *Internal Revenue Code*;
   6. Insurance companies subject to the Arkansas insurance premium tax and therefore exempt from Arkansas income tax pursuant to § 26-57-602; or
   7. Non-resident members who have submitted an affidavit (Form AR4PT) that meets the following requirements:
      a. In the affidavit, the non-resident member agrees to be subject to the personal jurisdiction of the Department and the courts of Arkansas for the purpose of determining and collecting any Arkansas taxes, including estimated tax payments, together with any related interest and penalties. See Section (J) of this rule for the procedure to be followed in filing the affidavit.

b. For non-resident partners filing Form AR4PT, the inclusion of the partners' income within the composite income tax return (AR1000CR) will satisfy the requirements contained in the affidavit.
c. For non-resident shareholders filing Form AR4PT, inclusion of the non-resident shareholder's income in the composite income tax return will satisfy the requirements contained in the affidavit.
d. For non-resident beneficiaries filing Form AR4PT, the inclusion of the beneficiary's income within the composite income tax return will satisfy the requirements contained in the affidavit.

E. <u>Withholding not required:</u> Withholding by a pass-through entity is not required in the following instances:
1. When an entity is not required to file a federal income tax return, or properly elects out of such duty;
2. When a pass-through entity is making distributions of income not subject to Arkansas income tax;
3. When a pass-through entity is making distributions to another pass-through entity. Provided however, the exception set out in this paragraph does not relieve the lower-tiered pass-through entity from the duty to withhold on distributions it makes which are not otherwise exempt;
4. When a pass-through entity is a publicly traded partnership, as defined by Section 7704(b) of the *Internal Revenue Code* (as in effect on January 1, 2005), and is treated as a partnership for purposes of the *Internal Revenue Code*. Provided, however, that the publicly traded partnership has agreed to file an annual information return reporting the name, address, taxpayer identification number, and any other information requested by the Department of each member with an annual Arkansas income greater than $500; or
5. When a distribution made by a pass-through entity has been determined not to be subject to withholding by the Department.

F. <u>Required reports and due dates</u>:
1. A pass-through entity is required to provide the Department with an annual return (Form AR941PT) that includes magnetic media (a CD or 3.5” diskette) showing to whom the distribution was paid on or before April 15 following the close of the pass-through entity’s tax year. The magnetic media must also include the non-resident member’s address, social security number or federal employer identification number, the amount of taxable income distributed and the amount of Arkansas income tax withheld and paid on the member’s behalf. The magnetic media should be labeled with the form number “AR941PT”, the pass-through entity’s name, federal employer identification number and the number of records contained on the disk or CD. The final version of the media layout will be posted on the Withholding Website. The annual return may be amended if necessary.
2. A pass-through entity must provide a non-resident member of the pass-through entity with an annual record (Form AR1099PT) of the amount of income distributed and the income tax withheld on behalf of the non-resident member no later than the 15th day of the third month following the end of the pass-through entity’s tax year. Copies of AR1099PT, along with AR1096, must be sent to the Department by the same date.

3. Each pass-through entity must file with the Department the appropriate income tax withholding return AR941PT on or before the due date of the pass-through entity's income tax return, including extensions.
4. Each non-resident member must enclose a copy of AR1099PT with their Arkansas income tax return as verification for this withholding.

G. Extensions of time to file reports: Any request for an extension beyond April 15 must be made in writing prior to April 15.

H. Credit or refund: Any non-resident member from whom Arkansas income tax is withheld pursuant to the provisions of this rule, and who files an Arkansas income tax return, is entitled to a credit for the amount of Arkansas income tax withheld. If the amount withheld is greater than the Arkansas income tax due, the non-resident member will be entitled to a refund of the amount of the overpayment.

I. Registration: Pass-through entities that make distributions subject to Arkansas withholding must register with the Department using Form AR4ER. **IMPORTANT**: When completing the AR4ER, check the "Pass Through Entity" box and add the two digit processing suffix number, seventy (70), to your FEIN (ex: 12-3456789-**70**). **YOU MUST** use the processing number on all related forms for pass-through withholding tax remittance. If this processing number is not included with your FEIN, processing of your payments will be delayed.

J. Affidavit filing procedures: Non-resident members who elect to file an affidavit (Form AR4PT) agreeing to be subject to the personal jurisdiction of the Department and the courts of Arkansas for the purpose of determining and collecting any Arkansas taxes, including estimated tax payments, and any related interest and penalties, must remit the affidavit to the appropriate pass-through entity. The pass-through entity is to retain the affidavit and file the following information with the Department by the due date of the required annual tax return of the pass-through entity.
   1. Content: The name, address, and social security number or federal identification number of the non-resident member having a signed Form AR4PT. All pass-through entities are required to file the non-resident member withholding exemption affidavit information on a diskette or CD with the Withholding Branch of the Department's Individual Income Tax Section.
   2. Format: The format for filing the diskette or CD will be in either a spreadsheet format (such as *Excel*) or a database format (such as *Access*). The final format will be posted on the Department's withholding tax website by December 15, 2006.
   3. Waiver: A pass-through entity may obtain a waiver from the diskette or CD filing requirement if the pass-through entity can demonstrate that a hardship would result if it were required to file on a diskette or CD. Direct waiver requests to the Withholding Branch of the Department's Individual Income Tax Section.

K. Deductions, Adjustments and Credits: The Arkansas income tax due on a composite return (Form AR1000CR) shall not be reduced by a pass-through entity non-resident member's allowable Arkansas business incentive income tax credits nor any other deductions, adjustments or credits. A non-resident member must file a return on Form AR1000NR to claim any deductions, adjustments or credits.

Issued this _______ day of September 2007.

____
Richard A. Weiss, Director
Arkansas Department of Finance and Administration

____
Tim Leathers, Deputy Director/
Commissioner of Revenue
Arkansas Department of Finance and Administration