



MULTISTATE INCOME/FRANCHISE TAX

Nonresident withholding considerations under California's pass-through entity tax regime

Tax Alert

Overview

California's recently enacted pass-through entity tax ("PET") presents potential issues for taxpayers subject to California's nonresident withholding requirements. (See our previously issued [Tax Alert](#) for more details about this tax and [updates](#) made by [Senate Bill 113](#) (S.B. 113)). Qualified entities electing into the California PET are required to withhold and remit tax at 7% for domestic nonresident individual owners and 12.3% for foreign (non-U.S.) individual owners including those who consent to have their pro rata or distributive share of income subject to the California PET. For tax years beginning on or after January 1, 2022, nonresident withholding credits must be utilized before the California PET credit, thus risking loss of any California PET credit that cannot be utilized before the five-year credit carryforward period expires.

Consenting domestic nonresident owners should consider requesting a nonresident withholding waiver. There is no withholding waiver available for foreign (non-U.S.) owners. However, consenting foreign (non-U.S.) owners should consider requesting nonresident reduced withholding to reduce the nonresident withholding tax rate below 12.3%.

Background

The California Franchise Tax Board's ("FTB") PET [frequently asked questions](#) explains that electing into the California PET regime does not affect a qualified entity's nonresident withholding requirement. As a result, an electing pass-through entity is required to continue to remit withholding on behalf of all nonresident owners including owners who consent to inclusion in the California PET regime. This could result in a qualified electing pass-through entity having remitted withholding at a rate of 7% on domestic nonresident owners and 12.3% on foreign owners in addition to paying California PET at a rate of 9.3%.

California Revenue and Taxation Code (“CRTC”) [§17039\(b\)](#) specifies that nonresident withholding credit is to be treated in the same manner as other state tax credit (“OSTC”) for purposes of credit utilization ordering. One of the changes made by S.B. 113 was amending CRTC §17039(b) so that for tax years beginning on or after January 1, 2022 OSTC is used before California PET credit. Accordingly, effective for tax years beginning on or after January 1, 2022, nonresident withholding credit must also be utilized before California PET credit. California PET credit is non-refundable but may be carried forward for five years before being lost. As a result of the credit utilization ordering rules, nonresident withholding may significantly impact the ability to utilize the California PET credit for nonresident owners before the five-year credit carryforward period expires.

Nonresident withholding waiver for domestic owners

Due to the issue explained above, for tax year 2022 and after, an electing pass-through entity should consider obtaining nonresident withholding waivers from domestic owners consenting to the California PET. California Form 588, Nonresident Withholding Waiver Request, can be filed to request a waiver from withholding on payments of California source income to nonresident domestic owners. Electing entities can file Form 588 on behalf of its partners/members/shareholders. Alternatively, nonresident partners/members/shareholders can file Form 588 with the FTB on their own and provide the waiver to the withholding agent (pass-through entity).

Form 588 must be filed at least 21 business days before making a payment to partners or members to allow the FTB time to process the request. The withholding agent/pass-through entity must have received the FTB approved waiver before eliminating withholding on payments to nonresident partners/members/shareholders.

Nonresident reduced withholding request for foreign (non-U.S.) owners

For foreign (non-U.S.) owners, careful consideration must be made when analyzing whether foreign owners consent to participate in the California PET regime. There is no waiver from withholding for Foreign (non-U.S.) owners. However, a foreign owner may file Form 589, Nonresident Reduced Withholding Request, to reduce the tax rate or eliminate an owner’s withholding tax obligation. The payee (foreign owner) must file Form 589 with the FTB before receiving payment of California source income. Form 589 must be received by the FTB at least 21 days before receiving payment if requested by mail and at least 10 days before receiving payment if Form 589 is filed online.

Takeaways

Qualified pass-through entities planning to elect into California’s PET regime should consider filing California Form 588, Nonresident Withholding Waiver Request, on behalf of their domestic, nonresident partners /members /shareholders.

To the extent foreign (non-U.S.) partners are consenting into the California PET, electing pass-through entities may want to consider obtaining a Form 589 to reduce the nonresident withholding rate below 12.3%.

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Have a question relating to this or any other pass-through entity tax regime? Reach out to one of our national multistate pass-through entity tax specialists.

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