

# The U.S. TAXFAX

## TOPIC: INVESTING IN U.S. REAL ESTATE BY PURCHASING PARTNERSHIP INTEREST

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In recent years, many of our clients have purchased units in limited partnerships investing in U.S. rental properties. This edition of the U.S.TAXFAX discusses the filing requirements for the partnerships, and the U.S. tax consequences for nonresidents aliens purchasing these types of investments.

### The Partnership's Requirements:

In general terms, the tax treatment of partnerships in the U.S. is the same as in Canada. Each partner is taxed on his or her share of partnership income, regardless of whether the income is actually distributed.

Partnerships have different filing requirements depending on whether they are considered foreign or domestic. Domestic partnerships are usually defined as partnerships that are created under U.S. law. Foreign partnerships are defined as those that are not domestic.

Domestic partnerships must file Form 1065, U.S. Partnership Return of Income, and report the worldwide income of the partnership and each partner's distributive share of this income. Foreign partnerships must file Form 1065 and report the partnership's U.S. source income (e.g. rents, capital gains from real property etc.) as well as each partner's distributive share of this income. If all the partners are nonresidents of the U.S., or the partnership keeps the records and books of account outside of the U.S., the due date for Form 1065 is the 15th day of the sixth month after the close of the partnership's year end. In all other cases, the due date is the 15th day of the fourth month after the close of the partnership's year end.

The partnership may be liable for various penalties and late filing fees if the return is filed late. The most onerous penalty, and one the IRS is very inflexible on, is \$50.00 per month that the return is late multiplied by the number of partners. We have seen this penalty applied on more than one occasion, and it often surprises a partner to know that they owe money to the IRS, even though the partnership was not profitable.

The partnership must also provide each partner with a written statement indicating the partner's distributive share of partnership income, gain, loss, deduction or credits. Form K-1, Partners Share of Income, Credits, Deductions, etc., is the form most often used by partnerships to report each partner's share of the above items.

If the partnership has income which is "effectively connected taxable income" (ECTI) and any portion of such income is allocable to a foreign partner, the partnership must withhold taxes with respect to such income. The withholding rate is the highest rate of tax applicable to that entity. For example, the partnership must withhold at a rate of 35% for nonresident corporations and 39.6% for nonresident individuals. The partnership must also provide to each foreign partner Form 8805, Foreign Partner's Information Statement of Section 1446 Withholding Tax, which indicates the tax withheld on behalf of the partner. The amounts withheld are eligible as a credit on the partner's U.S. income tax return. The general partner(s) have joint and several liability as withholding agents for this tax and may be subject to penalties of up to 25% of the tax that should have been withheld.

### The Partner's Requirements:

A partner investing in U.S. rental property through a partnership has the same U.S. filing requirements as if he/she owned the property personally. For a more complete discussion of the filing requirements for

nonresident aliens owning U.S. real estate, please refer to the first edition of the U.S. TAXFAX.

To summarize, the partner can choose the gross method of taxation in which case 30% of gross rents, without the benefit of deductions, must be withheld by the payer of the rents. If amounts are not withheld, the partner must file Form 1040NR, U.S. Nonresident Alien Income Tax Return, and submit the correct amount of withholding.

Instead of using the gross method of taxation, A partner may choose to report U.S. rents on a net basis and pay U.S. tax, if any, on the allocable share of partnership net rental income. This is usually the preferred method as the partner's share of net rental income often creates little or no tax liability. Net rental losses allocable to the partner can be carried forward to offset future rental income, or any capital gain on subsequent disposal of the property.

The partnerships which address their U.S. filing requirements and provide Form K-1's assume each partner will be electing to report U.S. rents on the net basis. As a result, the receipt of Form K-1 usually means that the partner is required to file a Form 1040NR. The partnership should also provide each foreign partner with Form 8805, indicating the taxes withheld on behalf of the partner. It is up to the partner to use Forms K-1 and 8805 to file Form 1040NR on or before June 15 following the calendar year end. A four month extension of time to file Form 1040NR can be obtained if Form 4868 is filed by June 15.

Clients often ask why they should file a Form 1040NR if the partnership is reporting a net loss from rental activities? The main reason is that if the net rental election is not made the partner must file Form 1040NR on the gross basis and submit 30% of the gross rents as tax. Periodic tax deposits are required throughout the year based upon each periods gross rents. Failure to make tax deposits may result in substantial penalties. Furthermore, by filing Form 1040NR on the net basis, the partner is ensuring that losses may be carried forward to offset any future partnership income. It should be noted that the IRS can disallow the net rental election, and mandate the 30% tax, if the return is not filed within 16 months of the original due date.

Another commonly asked question is how will the IRS ever find out about me and if they do, how can they collect the taxes when I am in Canada? One way the IRS can become aware of non filing partners is from the partnership return. A list of partners names,

addresses and IRS numbers must be filed with the partnership return.

The IRS has various means by which they ensure the proper amount of taxes are collected. One of these is the partnership's requirement to withhold taxes on any income allocable to the partner at the highest individual tax rate (i.e. 39.6%). The IRS also ensures taxes are collected by requiring purchasers of U.S. real estate to inquire about the residency status of the vendor. If the vendor is a foreign person (e.g. a foreign partnership), the purchasers escrow company must withhold 10% of the gross sale proceeds and remit this amount to the IRS. As the withheld amounts are often greater than the actual tax liability, the investor is forced to file a return if he/she wants a refund of his/her share of the withheld amounts. If prior years returns have not been filed, net losses from these years can not be used to offset the current years partnership income.

Many investors address the annual Federal filing requirements but ignore the State requirements. When a property is sold, and the vendor(s) are foreign persons, many States require taxes to be withheld by the purchaser. Rental losses from prior years will not be available to offset the capital gain if past State tax returns have not been filed.

Many partnerships are providing partners with the Canadian Form 5013, but are not addressing the U.S. compliance and withholding requirements. It is extremely important that investors in these partnerships ensure that the partnership is and will be complying with the U.S. filing requirements. The risks (to the partners and the partnership) associated with ignoring these filing requirements are substantial.

Please remember, the information presented is general in nature and does not constitute professional advice. It is recommended that accounting, legal or other professional advice should be sought before acting upon any of the information contained.