

1997

## Withholding Tax on Phantom Gain

Alan Appel

*New York Law School*, alan.appel@nyls.edu

Michael Hirschfield

Follow this and additional works at: [http://digitalcommons.nyls.edu/fac\\_articles\\_chapters](http://digitalcommons.nyls.edu/fac_articles_chapters)

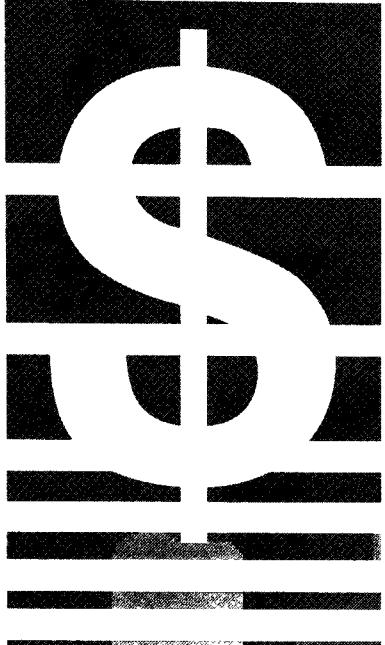
 Part of the [Property Law and Real Estate Commons](#), and the [Tax Law Commons](#)

---

### Recommended Citation

Practical Tax Lawyer, Vol. 11, Issue 2 (Winter 1997), pp. 43-50

This Article is brought to you for free and open access by the Faculty Scholarship at DigitalCommons@NYLS. It has been accepted for inclusion in Articles & Chapters by an authorized administrator of DigitalCommons@NYLS.



# Withholding Tax on Phantom Gain

**Alan I. Appel and Michael Hirschfeld**

*Here's a real dilemma:  
withholding money that isn't there.*

**GENERAL PARTNERS OF REAL ESTATE**  
(and other) partnerships which have any foreign persons as partners may be subject to civil penalty exposure if they fail to timely comply with the filing and withholding requirements of section 1446 of the Internal Revenue Code of 1986, as amended ("Code") (All section references are to the Code unless otherwise indicated.) These

withholding obligations become extremely problematic in foreclosure situations where the partnership may have taxable gain, which is allocable to the foreign partner, but typically has no cash to distribute to any of the partners. The general partner of such a partnership may have to deplete its own resources to avoid penalties.

---

**Alan I. Appel** is a member of the Tax Faculty of Baruch College of the City University of New York and the Vice Chair of the Committee on International Taxation of the Association of the Bar of the City of New York. **Michael Hirschfeld** is a partner in the New York law firm of Winston & Strawn, Chair of the Committee on Government Submission of the ABA's Section of Taxation and Co-Chair of the Committee on Real Property of the New York State Bar Association's Tax Section.

**PHANTOM INCOME SCENARIOS** • The phantom income problem can be seen in several different situations:

#### **The Foreclosure Problem: The Tufts Gain**

B is the general partner of a U. S. limited partnership ("ABC") which owns real estate in the United States that is subject to a \$10 million nonrecourse debt secured by a mortgage held by the Z bank. ABC has foreign persons as limited partners who are entitled to an allocation of 20 per cent of the income, gain, loss, deduction, and credits of the partnership. ABC has a basis in its real property which is secured by the mortgage held by the Z bank of \$8 million. Z bank forecloses on its mortgage of \$10 million which it holds to secure its loan to ABC. ABC has realized and recognized gain of \$2 million as a result of the foreclosure by Z bank.

#### **The Restricted Access to Cash Problem: The "Lock Box"**

ABC partnership has pledged all of its assets, including all cash rental income received, to Z bank to secure Z bank's loan.

ABC has allocations of effectively connected taxable income to the foreign partners but is restricted from making any cash distributions to these partners because of ABC's security arrangement with Z bank.

#### **Foreign Partner Fails To Make Required Capital Contribution**

ABC tried to anticipate the potential section 1446 problem by requiring in the partnership agreement a "call" by the general partner of any amounts necessary to fund the withholding tax. The foreign partners simply

breach their agreement to meet their obligation to fund the withholding tax amounts in a timely manner.

**THE WITHHOLDING PROBLEM** • Section 1446 requires the general partner to withhold at the rate of 39.6 per cent for individuals and 35 per cent for corporations on the allocation of "effectively connected taxable income" (which the gain described above would be) to the foreign partners. In the ABC scenario described above, the general partner of ABC is required to withhold 39.6 per cent of \$400,000 (or \$158,400) and remit this amount to the Internal Revenue Service ("IRS") even though the partnership did not receive any cash from which to withhold or that it could distribute to the foreign partners.

#### **Trouble for the General Partner**

As a withholding agent the general partner, under section 1461, is responsible for making the required partnership filings and for remitting the quarterly withholding payments to the IRS. If the general partner does not make the required filings or remit the withholding taxes, the general partner will be subject to civil and, in a rare case, criminal penalties for failure to file and to pay tax (including the trust fund recovery penalty under section 6672) as well as interest for failure to pay estimated taxes and to remit tax when due.

#### **Where To Look for Counsel?**

There are no regulations under section 1446. When first enacted in 1986, section 1446 only required withholding on actual cash distributions. It was amended in 1988 to require withholding on allocable gain. The IRS has

issued Rev. Proc. 89-31, 1989-1 C.B. 895, later modified by Rev. Proc. 92-66, 1992-2 C.B. 428, which set forth the requirements with respect to section 1446.

Under these revenue procedures, there is no section 1446 withholding required if the partnership actually had to withhold under section 1445 (FIRPTA withholding).

#### *Help from Section 1445 Regs?*

Treas. Reg. § 1.1445-2(d)(3)(i)(B) provides an exemption from the withholding requirements of section 1445 in the case of a foreclosure (or transfer of deed in lieu of foreclosure) where no cash is paid to the transferor of the property. Notwithstanding the logical approach of the regulations under section 1445, in the case of ABC, withholding is still required by section 1446 under Rev. Proc. 89-31 and Rev. Proc. 92-66 because there was no withholding required under section 1445 due to the lack of cash.

#### **Publicly Traded Partnerships**

Separate withholding requirements apply to publicly traded partnerships. Such partnerships withhold on actual cash distributions unless they elect to withhold on effectively connected income.

#### **One Way Out: Form W-9**

Certification of non-foreign status may be advisable. The partnership may rely on Form W-9.

Watch out for foreign partnerships that may be doing business in the United States. Those partnerships will also be subject to the section 1446 withholding requirements.

**FILING REQUIREMENTS•** Several forms must be filed by the partnership in ABC's position.

#### **Form 8804, "Annual Return For Partnership Withholding Tax"**

Form 8804 is used to report the section 1446 withholding tax liability of a partnership for its entire tax year. This form should be filed on or before the fifteenth day of the fourth month following the close of the partnership's tax year along with copies of Form 8805. Failure to file this form could result in a penalty assessment of five per cent of the net unpaid tax if the failure is for 30 days or less. For each additional month (or fraction of a month) that the return remains outstanding, an additional five per cent of the net unpaid tax will be assessed as a penalty up to a maximum of 25 per cent. If the failure to file is found to be due to fraud, the penalties will increase to 15 per cent of the net unpaid tax per month to a maximum of 75 per cent.

#### **Form 8805, "Foreign Partner's Information Statement of Section 1446 Withholding Tax"**

Form 8805 reports the amount of effectively connected taxable income allocable to each non-U.S. partner and the amount of that income that has been withheld on behalf of each partner for the tax year. This form needs to be filed on or before the fifteenth day of the fourth month after the close of the partnership's tax year. A Form 8805 must be filed for each individual non-U.S. partner regardless of whether effectively connected net income was earned during the year.

MORE ALI-ABA RESOURCES  
ON PARTNERSHIPS

---

CALL 1-800-CLE-NEWS AND ASK FOR CUSTOMER SERVICE  
TO OBTAIN ANY OF THE FOLLOWING PRODUCTS:

**COURSES**

**Qualified Plans, Professional Organizations, Health Care, and Welfare Benefits** (Scottsdale, Arizona, Feb. 13-15; \$685)

**Corporate Mergers and Acquisitions** (San Francisco, March 6-7; \$685)

**Tax, Business, and Succession Planning for the Growing Company** (Ft. Lauderdale, March 6-8; \$685)

**Video Law Review: Limited Liability Vehicles: LLPs, LLCs, LPs, and LLPs** (Various cities, March 20; \$160)

**BOOKS**

**Federal Income Taxation of Partners and Partnerships**, by Stephen Utz (3d ed. 1995; \$155.50)

**Partnership and LLC Litigation Manual: Actions for Accounting and Other Remedies**, by James R. Burkhard (1995; \$222.50)

**Tax Court Practice**, by Marshall W. Taylor, Karen J. Simonson, Marc J. Winter, and Brian J. Seery (8th ed. 1993; \$119.75)

**The Drafting of Partnership Agreements**, by Marlin M. Volz, C. Christopher Trower, and Debbie F. Reiss (7th ed. 1986; \$79.25)

**Resource Materials: Partnerships and Limited Liability Companies** (11th ed. 1994; \$86.40)

**PERIODICALS**

**Using Partnerships To Plan for Life Insurance**, by S. Stacy Eastland, *The Practical Tax Lawyer*, Spring 1993, p. 65 (Part 1); Summer 1993, p. 39 (Part 2)(\$21.50)

**The Return of the Partnership Freeze**, by Robert L. Weitzner, *The Practical Tax Lawyer*, Fall 1992, p. 75 (10.75)

ORDER 24 HOURS A DAY VIA OUR HOME PAGE AT

<http://www.ali-aba.org>

### ***Penalties for Failure To File***

Failure to file Form 8805 with the IRS by the due date or failure to include all information in the return could result in a penalty of \$50 per return required to be filed. The maximum penalty is \$ 250,000. Failures corrected within 30 days of the due date will result in a penalty of \$15 per return to a maximum of \$75,000 and failures corrected by August 1 of the calendar year in which the due date falls will have a penalty of \$30 per return to a maximum of \$150,000. The maximum penalties are reduced if the partnership has gross receipts of less than \$5 million.

If the IRS determines the failure to file was due to intentional disregard, the penalty will be the greater of \$100 per return required to be filed or 10 per cent of the aggregate amount required to be reported correctly on each return. For example, if the amount required to be reported was \$100,000 of effectively connected net taxable income and \$39,600 of withholding and only \$50,000 of net income was correctly reported, the penalty would be the greater of \$5,000 ( $50,000 \times .10$ ) or \$100 per required return. There is no maximum penalty limitation for intentional disregard penalties.

A penalty may also be imposed for failure to furnish a correct Form 8805 to each non-U.S. partner. The penalty assessed will be \$50 per return required to be filed with a maximum penalty of \$100,000. If the failure to file was due to intentional disregard, then the additional penalties outlined above apply to this case as well.

### ***Form 8813, "Partnership Withholding Tax Payment"***

A partnership is required to remit quarterly installments of estimated withholding tax on behalf of its non-U.S. partners. The installments are calculated based only on the non-U.S. partners' allocable share of partnership effectively connected income. Form 8813 is filed by the partnership with its quarterly payments of withholding taxes. The payments are due on or before the fifteenth day of the fourth, sixth, ninth and twelfth months of the partnership's tax year.

Failure to pay the quarterly installments of estimated taxes will result in an underpayment penalty. The penalty is the amount of the installment underpayment calculated at the underpayment rate (which is the Federal short term interest rate plus three percentage points; currently nine per cent) for the underpayment period. The underpayment period runs from the due date of the installment to the earlier of the fifteenth day of the fourth month following the close of the taxable year (due date of Forms 8804 and 8805) or the date on which the payment is made. For example, if an installment was due on September fifteenth and the fourth month following the close of the partnership's tax year is April 15, then the underpayment period would be seven months.

### ***Failure To Pay Tax***

In addition, a penalty will be assessed for failure to pay the total amount of the withholding tax liability by the unextended due date of Forms 8804 and 8805. This penalty is one half of one per cent of the net tax due for each month (or fraction of a month) the tax is not paid. If the tax is not paid with-

in 10 days after a notice and demand for payment has been issued by the IRS, an additional one half of one per cent will be assessed on all outstanding tax due. The maximum applicable penalty is 25 per cent of the net tax due. In addition, interest will be charged on all amounts due and unpaid from the unextended due date of Forms 8804 and 8805 to the day the payment is made. The penalty interest rate is the same as the underpayment rate for estimated taxes. A civil penalty may also be assessed for failure to collect and pay over tax.

If the withholding agent "willfully" fails to collect tax or to truthfully account for the tax and pay over such tax, he or she may be subject to a penalty equal to the total amount of tax not collected or accounted for and not paid over.

**FINANCIAL CONSEQUENCES** • The financial consequences of not complying with section 1446 withholding can be very significant. The numerous penalties and interest payments combined with the actual withholding tax liability itself can become a large financial burden to the withholding agent.

Even though the actual income tax liability rests with the individual partners, if the withholding agent has failed to withhold or has withheld incorrectly, the withholding agent remains liable for the partners' payment of those taxes.

In the Appendix, we have prepared a comprehensive example of what the effect of these financial consequences could be. This example is for illustrative purposes only. In the example, a company with approximately \$200,000 of effectively connected taxable income would be subject to interest and penalties in the amount of \$42,017 in addition to a withholding tax liability of \$79,200. The total amount due to the IRS would be \$121,217.

Finally, we would point out that a partnership's U.S. effectively connected taxable income is computed by applying U.S. tax rules to each quarter, essentially as if the quarter were a full taxable year. Accordingly, the usual standards for deductibility (proper accrual, economic performance, etc.) must be satisfied at the end of each quarter for a deduction to be taken in computing effectively connected taxable income.

**APPENDIX**  
**Comprehensive Example of Section 1446 Withholding**

To illustrate the application of section 1446, we will apply the penalty and interest calculations to the ABC Limited Partnership. We will assume that no filings or payments of withholding will be made and that all partners are non-corporate entities. These calculations are for illustrative purposes only and are not intended to be used as an estimate for an actual IRS assessment.

Annualized effectively connected net income	\$200,000
Year-end December 31 required withholding tax payments	\$ 79,200
Required quarterly installment payments	\$ 19,800
Number of non-U.S. partners: 116; tax liability paid on September 30 of the following year	

**Penalties:**

Failure to file Form 8804 Maximum penalty (filed 5 months past due date or never filed) (.25 × 79,200)	\$ 19,800
--	-----------

Failure to file Form 8805 (116 non-U.S. partners) Maximum penalty (filed later than August 1) (\$50 × 116)	\$ 5,800
---	----------

Failure to send Form 8805 to Recipients Penalty (\$50 × 116)	\$ 5,800
--	----------

Failure to pay estimated taxes; minimum penalty (quarterly payments due April 15, June 15, September 15, and December 15 paid in one payment on September 30 of the following year)	.
--	---

$$12/12 \times .09 \times \$19,800 = \$1,782$$

$$10/12 \times .09 \times \$19,800 = \$1,485$$

$$7/12 \times .09 \times \$19,800 = \$1,039$$

$$4.5/12 \times .09 \times \$19,800 = \$668$$

\$ 4,974
----------

Since the due date of Forms 8804 and 8805 is April 15, the underpayment period for estimated tax ends on this date. However, this is the beginning date of the "non-payment of tax" period that runs until the tax is paid. The interest charged during this period is based on the Federal short term interest rate plus three percentage points.

Interest applicable to "non-payment of tax" (5.5/12 × .09 × 79,200)	\$ 3,267
---	----------

Failure to pay tax when due maximum penalty (paid on September 30 and no notice of assessment has been filed) (.03 x 79,200)	<u>\$ 2,376</u>
Total interest and penalties	\$ 42,017
(All penalties and interest are in addition to calculated tax liability)	
<b>TOTAL DUE</b>	
Tax due	\$ 79,200
Interest and penalties	<u>42,017</u>
	<u><u>\$121,217</u></u>

#### **PRACTICE CHECKLIST FOR Withholding Tax on Phantom Gain**

General partners of real estate (and other) partnerships which have any foreign persons as partners may be subject to civil penalty exposure if they fail to timely comply with the filing and withholding requirements of section 1446 of Code.

- These withholding obligations become extremely problematic in foreclosure situations where the partnership may have taxable gain, which is allocable to the foreign partner, but typically has no cash to distribute to any of the partners. In these cases, there is little that the general partner can do.
  - Check if there is any chance that section 1445 can be relied on;
  - Consider use of a publicly traded partnership;
  - Can non-foreign status be certified under form W-9?
- The general partner will want to be very sure to file all the required returns for the partnership, including:
  - Form 8804: Annual Return for Partnership Withholding Tax;
  - Form 8805: Foreign Partner's Information Statement of Section 1446 Withholding Tax;
  - Form 8813: Partnership Withholding Tax Payment.