THE NAPPA REPORT

What Do You Mean We're Subject To A Withholding Tax?

The Growing Trend Among States to Withhold Taxes On the Sale of Real Estate by Non-Residents

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A public pension fund, as a tax exempt organization, should have little concern over the application of state income tax withholding requirements associated with the sale of commercial real estate, right? Well, that may not necessarily be true. Regardless whether the pension fund is the seller or the buyer, if the fund is not careful in following certain procedures leading up to closing, there will be tax consequences. At a minimum, the pension fund will have taxes withheld at closing and later have to seek a tax refund. In the worst case scenario, the pension fund may be held responsible for the tax liability of the other party.

Since its enactment in 1980, those of us involved in real estate transactions have become well versed with the withholding requirements of the federal Foreign Investment in Real Property Tax Act ("FIRPTA"). What many people may not realize is that a number of states have followed suit with their own version of FIRPTA. At least eight states currently apply tax withholding requirements on the sale of real property by individuals, corporations, LLCs and other entities who are not residents of the state. California, Georgia, Hawaii, Mississippi, Maryland, Rhode Island, South Carolina, and Vermont all have implemented state withholding requirements for the sale of real property by nonresidents. The amount of the withhold varies from state to state, ranging from 2.5% to as much as 9% of the taxable amount of the transaction. Some states base the tax on the gain recognized by the seller, other states focus on the net proceeds, and at least one state bases the tax on the gross sales price for the property.

Who is a "resident" varies from state to state. In five of the jurisdictions (California, Hawaii, Mississippi, Maryland and Rhode Island), an entity will qualify as a resident of the state if it either is formed under the laws of that state or is properly registered to do business within that state. If your fund holds title to real estate in its own name, or in the name of an entity that traditionally does not qualify to do business in a state (for example, a general partnership), that test may be difficult to pass. If your fund holds title in the name of a limited liability company or other nominee, to be considered a "resident," that entity, at a minimum, must be formed under the laws of the state in which the property is located or must formally qualify to do business in that state.

Georgia, South Carolina and Vermont are even more restrictive. In Georgia, the seller will be deemed a resident of the state only if it: (a) has filed Georgia income tax returns or appropriate extensions for the two years immediately preceding the year of the sale; (b) either is doing business in Georgia and will continue "substantially" in the same business after the sale or the seller or transferor has real property remaining in the state at the time of closing equal or greater in value than the tax liability of the property sold; (c) will report the sale on its Georgia income tax return for the year in which the property was sold; and (d) if the seller is a corporation, limited partnership or other entity that must qualify to do business in the state, it must be currently registered to do business in Georgia.

In South Carolina, in addition to qualifying to do business within the state, the seller must also have been in business in South Carolina during the two tax years immediately preceding the sale and have filed income tax returns for at least one of those years. To be a resident of Vermont, the seller must either (i) have been formed under the laws of state, or (ii) both maintain its principal place of business in Vermont and not conduct business in the state in which it was originally formed.

In all eight states, unless the seller is deemed to be a resident of the state in which the property is located, tax will be withheld on the sale of the property unless the seller qualifies for an exemption and follows the procedures necessary to obtain that exemption. While public pension funds, as tax exempt organizations, generally qualify for exemptions in these states, the exemptions are only available if the appropriate procedures have been followed. As a result, a little advance planning can prevent unexpected and undesired consequences.

Each of the states with a mini-FIRPTA law has a certification process that relieves an exempt seller from having taxes withheld at closing. The appropriate certificate must be presented to the buyer at closing or the tax will be withheld. There is no discretion involved, and the tax must be withheld absent the necessary certificate. In some states, the exemption certificate is, in effect, an affidavit by the seller certifying that it is exempt from the withholding requirements of that state. In other states, the exemption certificate can only be obtained by application to the state tax authority. In Maryland, for example, the seller must submit an application for an exemption certificate to the Office of the Comptroller. The Office of the Comptroller will issue the exemption certificate to the seller if it determines that the transfer is not subject to the withhold requirement. This process may take up to several weeks to complete. Accordingly, a fund or other non-resident entity contemplating the sale of commercial property in Maryland must be sure to submit its application for an exemption certificate well in advance of the sale in order to guarantee receipt of the certificate prior to closing. Otherwise, the seller will be subject to withholding at the time of transfer and forced to seek a refund from the Office of the Comptroller after the closing.

Buyers, too, cannot afford to ignore this issue without exposing themselves to significant liabilities. With the exception of Maryland, which places the liability for withholding and remitting the tax solely on the seller, each state that has established a withholding requirement for the sale of real property by a nonresident places the responsibility on the buyer to collect and remit the withhold at the time of transfer. The buyer is held personally liable for any withhold amounts not collected from the seller and remitted to the state tax authority. Accordingly, if your fund is the buyer, you need to pay particular attention to the exemption requirements of the state where the property is located (i) to determine whether withholding is required, and (ii) if so, and an exemption is claimed by the seller, to confirm that any exemption certificate presented by the seller is in accordance with the specific requirements of the particular state. If not, your fund could be left paying a large sum to the state for a withholding tax that should have been paid by the seller.

Given the intricacies and specialized requirements of the various state withholding laws, pension funds and other tax exempt organizations engaged in the purchase or sale of real estate within the United States would be wise to consult with counsel or other real estate professionals experienced in the applicable state's real estate tax withholding issues to ensure that proper procedures are followed to avoid withhold obligations on their next transfer.

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