

Caveat Emptor for Alabama Real Estate Buyers: Tax Withholding Obligations Now Exist

by

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Beginning August 1, 2008, buyers, transferees and closing agents involved in Alabama real estate transactions must be mindful of new obligations to withhold and remit to the Alabama Department of Revenue (“**ADOR**”) a percentage of the purchase price otherwise payable to a nonresident of Alabama that sells or transfers Alabama real estate. With the recent passage of Act 2008-504 (the “**Act**”), Alabama sails a similar course charted by numerous other states imposing tax withholding obligations on parties to real estate transactions.¹

Summary of Alabama Tax Withholding Act

The Act applies to a sale of Alabama real estate by a seller that is a nonresident of Alabama. The Act and related forms² published by ADOR permit a seller that is a nonresident of Alabama to establish (for purposes of withholding obligations) Alabama residency by affirming to the buyer by sworn affidavit that the seller is an Alabama resident or the seller satisfies each of the following four conditions:

1. Seller has filed Alabama income tax returns for the 2 prior tax years; **and**
2. Seller is presently in business in Alabama and will continue substantially the same business after the sale **or** Seller has other real property in Alabama at the time of closing of equal or greater value than the withholding tax liability as measured by 100% of the tax assessed value; **and**
3. Seller will report the subject sale on an Alabama income tax return for the year of sale and file the Alabama income tax return by the due date with any applicable extensions; **and**
4. If Seller is a corporation or limited partnership, Seller is registered to do business in Alabama.

There are 2 basic methods for calculating the amount to be withheld by the buyer of Alabama real estate from a nonresident of Alabama. Under the first method, an individual buyer

¹ See California (Cal. Rev. & Tax. Code Sec. 18662 (West 2008)); Colorado (Colo. Rev. Stat. Sec. 39-22-604.5 (2007)); Georgia (Ga. Code Ann. Sec. 48-7-128 (West 2008)); Hawaii (Haw. Rev. Stat. Sec. 235-68 (West 2007)); Maine (Me. Rev. Stat. Ann. tit. 36, Sec. 5250-A (1995)); Maryland (Md. Code Regs. 03.04.12.01 (2008)); Mississippi (Miss. Code Ann. Sec. 27-7-308 (1972)); New Jersey (N.J. Stat. Ann. Sec. 54A:8-9 (2005)); New York (N.Y. Tax Law Sec. 663 (2004)); Oregon (See 2008 Or. Law 1st Sp. Sess. Ch. 54(S.B. 1101)); Rhode Island (R.I. Gen. Laws Sec. 44-30-71); South Carolina (S.C. Code Ann. Sec. 12-8-580 (2007)); and Vermont (Vt. Stat. Ann. tit. 32, Sec. 5847 (1997)), all of which impose laws similar to the Act.

² It is important to note that these recently promulgated forms are not ADOR regulations. Although it is anticipated that ADOR will issue formal regulations to interpret certain provisions of the Act, there have been no official regulations promulgated by ADOR at this time.

must withhold 3% of the purchase price, while a corporation, partnership or unincorporated association or other entity buyer (such as an LLC) must withhold 4% of the purchase price. Under the second method, an Alabama nonresident seller may affirm to the buyer by sworn affidavit the amount of gain recognized by the seller on the transaction, and the applicable withholding rate would then apply only to the gain amount. Under either calculation method, the buyer (a) must file the required tax return and remit the applicable withholding amount to ADOR by the last day of the calendar month following the month that the Alabama real estate transaction closed, and (b) shall not withhold and remit an amount greater than the net proceeds payable to the seller from the real estate transaction.

Noteworthy Alabama Tax Withholding Act Issues for Practitioners

The Act creates a number of unresolved issues which transaction parties must handle in connection with a closing. Although not comprehensive, the following discussion highlights issues implicated by the Act that are of particular importance to real estate practitioners:

1. *Tax-Free Exchanges*: Transferors of property often engage in tax-free exchanges under IRC Section 1031 in order to defer taxable gain which would otherwise be recognizable. Although the Act does not expressly exempt tax-free exchanges from the withholding obligations, ADOR has recently issued certain Frequently Asked Questions [Concerning] Withholding on Sales/Transfers of Real Property and Associated Tangible Personal Property by Nonresidents (Act 2008-504) (the “*FAQs*”), which state that “[w]ithholding is not required to the extent that the income from the sale is not subject to Alabama income tax.” Because income from a 1031 transaction is not subject to Alabama income tax, the *FAQs* suggest that the withholding obligations do not apply in a 1031 transaction. However, because the *FAQs* are provided by ADOR as guidance in advance of regulations, it is anticipated that such regulations or perhaps even a statutory amendment will specifically address this issue.

2. *Single Asset Entities*: For numerous planning reasons, real estate is often titled in an entity whose sole asset is that single piece of real estate. If a non-resident³ single asset entity (i.e., one that is neither organized under Alabama law nor maintains its principal place of business in Alabama) sells its real estate, then the buyer will be required to withhold the applicable percentage of the purchase price from the sales proceeds. Such a seller would fail the second prong of the 4-prong Alabama residency test because it would not likely substantially continue the same business after the closing or own any other Alabama real estate at the time of the closing. In certain circumstances, Alabama composite tax return filers are exempt from the Act’s withholding requirements, which may assist certain non-resident transaction parties. The disparity created by ADOR’s favoring residents over non-residents under these circumstances may be subject to attack as violative of the Commerce Clause of the U.S. Constitution.

3. *Liability For Act Compliance*: The parties involved in a modern commercial real estate closing rarely are all in the same room to close the transaction. Indeed, a typical commercial closing involves representatives of the seller and buyer overnighting closing documents with an escrow instruction letter to a settlement agent, who is charged with handling the receipts and disbursements involved in the transaction and charged with drafting a closing statement to accurately reflect those receipts and disbursements. Although the Act solely imposes

³The recently published ADOR instructions for the Alabama residency affidavit under the Act exempt Alabama residents, including individuals and business entities either organized under Alabama law or with their principal place of business in Alabama, from the Act’s withholding requirements.

liability on the buyer relating to violations of its provisions, a settlement agent involved in a transaction with parties represented by out-of-state counsel should nevertheless be proactive in disclosing the Act's provisions to the parties. Such disclosure should likely involve having the transaction parties execute a written acknowledgment describing the Act's terms, which might also include a provision whereby the parties indemnify the settlement agent for any potential exposure it may incur under the Act. ADOR should consider issuing future written guidance to explicitly limit a settlement agent's exposure under the Act to alleviate these concerns.

4. *Purchase Price Thresholds:* Practitioners should be mindful that ADOR has provided written guidance concerning certain purchase price thresholds, affording an additional exemption from the Act's withholding requirements. Issued in connection with the FAQs, this exemption applies to any transaction with a purchase price less than \$800,000 which closes after August 1, 2008 but prior to January 1, 2009, and any transaction with a purchase price less than \$300,000 which closes after December 31, 2008.

Where to Find More Information About the Alabama Tax Withholding Act

The FAQs are available for review in full at ADOR's website at www.revenue.alabama.gov/incometax/nonresidentwh.htm, together with the following forms promulgated by ADOR which are intended to facilitate compliance with the Act: (i) Form NR-AF1 (Affidavit of Seller's Residence); (ii) Form NR-AF2 (Affidavit of Seller's Gain); (iii) Form NR-AF3 (Seller's Certificate of Exemption); and (iv) Form WNR-V (withholding on Sales or Transfers of Real Property and Associated Tangible Personal Property by Nonresidents Payment Voucher). Copies of each of these four forms follow this article.