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The Impact of State-Specific Nonresident Withholding Requirements on a §1031 Exchange

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In today's real estate market, many real estate investors invest in states other than where they reside. For investors taking advantage of the tax deferral offered under §1031 by structuring a like-kind exchange, it is not unusual to see sales of real estate by nonresidents. A handful of states have state nonresident withholding requirements for real estate sales that apply to the gain for state income tax purposes. Common wisdom might lead a nonresident seller to assume that if they are treating the sale as relinquished property in a §1031 exchange, the nonresident withholding would not apply. Beware! This assumption may catch a nonresident seller unaware. In some states there is either a waiver process to avoid nonresident withholding in a §1031 exchange, or an exception to withholding if there is a §1031 exchange. Paying the required withholding out of the net sales proceeds of the relinquished property may have a negative tax consequence. The payment of the tax could result in "boot" in the exchange, because a portion of the property sales proceeds were used to pay a tax rather than to purchase replacement property. Typically, the taxpayer would receive a refund of the tax paid if he is successful in deferring gain recognition because of the exchange. This can create a real dilemma! Below is a summary of the nonresident withholding requirements for some states in which ITEC has facilitated exchanges.

Alabama Ala. Code Section 40-18-86 requires withholding on the sale of real property by nonresident individuals, trusts, partnerships, corporations, limited liability companies, limited liability partnerships, and unincorporated organizations. The withholding amount is 3 percent or 4 percent of the purchase price or the seller's gain, if the seller completes Form NR-AF2 (Affidavit of Seller's Gain). Transfers where there is complete nonrecognition of gain by the seller are exempt from withholding. Transfers where gain is partially recognized are subject to withholding only to the extent of the recognized gain. If the exemption applies, the seller should complete Form NR-AF3 (Seller's Certificate of Exemption). If any money remains in the exchange after the expiration of the exchange period, this exemption will apply only if the seller agrees to have the qualified intermediary (QI) remit any payment due to the Alabama Department of Revenue.

California Pursuant to California Franchise Tax Board Publication 1016 (rev. 06-2009), all sellers of California relinquished property are subject to withholding, regardless of whether or not they are residents of California. Each seller is required to complete Form 593-C (Real Estate Withholding Certificate) and submit it to the withholding agent. The withholding amount is 3.33 percent of the sales price, or, in the alternative, withholding may be based on the gain at specific rates according to the type of seller. Sellers doing §1031 exchanges are exempt from withholding, but if the exchange fails, the QI must withhold the appropriate amount. If there is more than $1,500,000 of taxable boot in the exchange, the QI must withhold 3.33 percent of the boot. Any withholding should be submitted to the CA Franchise Tax Board along with Form 593 (Real Estate Withholding Tax Statement).

Hawaii Pursuant to Section 235-68, Hawaii Revised Statutes (HRS), a buyer of Hawaii real property must withhold tax if the seller is a nonresident person or entity. In order to avoid withholding, the taxpayer must certify that they are exempt by filing Form N-289 (Certification for Exemption from the Withholding Tax), request a waiver or adjustment of the amount withheld using Form N-288 (Application for Withholding Certificate), or allow 5 percent of the amount realized to be withheld at closing using Form N-288 (Hawaii Withholding Tax Return) and Form N-288A (Statement of Withholding). It is generally understood that if withholding is required, the taxpayer should be able to pay an equivalent amount from separate funds into the exchange at closing, and he may be able to offset boot recognition by funds he paid into the transaction. Then, if he ultimately owes no tax to Hawaii, he can file for a refund.

Maine A buyer of Maine real property must withhold tax in the amount of 2.5 percent of the sales price if the seller is a nonresident individual, estate or trust, or a business not domiciled in Maine by filing Form REW-1 (Real Estate Withholding Return for Transfer of Real Property). A seller who is effecting a §1031 exchange may apply for an exemption from withholding at least five business days prior to closing by submitting Form REW-5 (Request for Exemption or Reduction in Withholding) along with a copy of the Exchange Agreement.

Maryland Pursuant to Section 10-912 of the Tax-General Article, Annotated Code of Maryland, withholding is required on the sale of real property by a nonresident individual or entity. The withholding amount is 7.5 percent of the total payment to a nonresident individual or 8.25 percent of the total payment to a nonresident entity, using Form MW506NRS (Return of Income Tax Withholding for Nonresident Sale of Real Property). In order to avoid withholding, the taxpayer must apply for a Certificate of Full or Partial Exemption from the Maryland Comptroller's office at least 21 days before closing, using Form MW506AE (Application for a Certificate of Full or Partial Exemption). The QI is required to send a letter, along with the exemption form, certifying that there will be no cash boot to the taxpayer. If the taxpayer receives any boot in the exchange, he will still need to file a return and pay taxes to both the IRS and the State of Maryland.

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New Jersey Pursuant to New Jersey P.L. 2005, Chapter 20, Assembly No. 3510, nonresident individual estates, or trusts who sell New Jersey property are subject to withholding. The withholding amount is determined by multiplying the gain on the sale of the property by the highest gross income tax rate of 8.97 percent. In order to avoid withholding, the taxpayer must request an exemption using Form GIT/REP-3 (Seller's Certification of Residency/Exemption) and indicate that the gain is not intended to be recognized pursuant to IRC §1031, or pay estimated tax prior to or at closing using Form NJ-1040ES (New Jersey Gross Income Tax Declaration of Estimated Tax). If taxes are paid prior to or at closing, the seller will receive a Nonresident Seller's Tax Prepayment Receipt (Form GIT/REP-2). If the taxpayer receives boot or if the exchange fails, the QI must withhold 2 percent of the value of the boot received or 2 percent of the total consideration if the exchange fails.

New York Pursuant to New York State Tax Law - Article 22, Section 663, nonresident individual, estate or trust sellers of New York relinquished property are subject to withholding. The withholding amount is determined by multiplying the gain by the highest applicable rate of New York State personal income tax in effect for the taxable year. In order to avoid withholding, the taxpayer must certify that no tax will be due in Part III of Form IT-2663 (Nonresident Real Property Estimated Income Tax Payment Form). Because it is unclear whether or not he can make that certification in a deferred exchange, he should consult with his tax advisor before choosing this option.

Oregon OR Section 314.258 requires withholding on the sale of real property where the seller is a nonresident individual or a C corporation not doing business in Oregon. Tax must be withheld unless the seller submits an exemption form (Form WC) prior to the closing of replacement property. There is an exemption if the seller intends to defer tax under §1031 or §1033. Withholding is the lesser of: 4 percent of the consideration; 8 percent of the gain; or the net proceeds (the amount disbursed to the taxpayer, including boot). The seller must provide the authorized agent a calculation of the withholding amount on Form WC and the authorized agent is entitled to rely on the seller's calculation. If the seller does not provide the authorized agent with a form WC, the authorized agent must withhold 4 percent of the consideration or the entire net proceeds, whichever is less. The authorized agent must submit Form WC to the state within 30 days from closing. If there is withholding, the authorized agent must tender it to the State within 20 days of disbursal, along with the tax payment voucher ("TPV") form, and must provide Form OR-18 to the seller.

South Carolina South Carolina Code Section 12-8-580 requires any person who purchases real property from a nonresident individual, corporation, partnership, trust or estate to withhold South Carolina income taxes from the seller. South Carolina Revenue Advisory Bulletin #02-6 provides guidance on how to apply this regulation. Form I-290 (Nonresident Real Estate Withholding) is used to determine the amount to be withheld. It will be based on either the gain provided by seller on Form I-295 (Seller's Affidavit) or on the amount realized, if Form I-295 is not provided. The amount withheld is 7 percent if the seller is not a corporation and 5 percent if the seller is a corporation. The buyer must remit the withholding amount on or before the 15th day of the month following the month in which the sale takes place, but may be extended if the seller is effecting a §1031 exchange. The seller will report the sale or the exchange on its South Carolina income tax return.

The seller has two options for remitting the required withholding: The first is to pay the withholding out of his own funds at closing, instead of using a portion of the sales proceeds. This prevents using exchange funds for the nonexchange expense of withholding tax. The second option is to shift the burden for paying the withholding amount to the QI. Although the responsibility may be shifted, the liability for the withholding remains with the buyer. The seller will fill out Form I-295 stating that it is intended that the transfer qualify as a nontaxable like-kind exchange under IRC §1031. The seller must also fill out Form I-290 as if the sale were taxable. The QI will hold the Form I-290 in escrow until the exchange is complete. The seller will need to provide the realized gain on Form I-295 in order to avoid calculating the withholding amount based on the sales price. It will be tempting for the seller to fill in "zero" gain, since he is doing an exchange, but the Advisory Bulletin clearly states that the I-290 must be completed as if the transaction were taxable. Once it appears that the transaction will not "qualify" (i.e., be fully tax-deferred), the QI is required, under the contract with Buyer, to withhold money from the seller's exchange funds to meet the withholding requirements. The QI must remit the I-290 and withholding amount by the 15th day of the month following the month it becomes apparent that the exchange will not qualify. If it appears that the transaction will fully qualify as a nontaxable like-kind exchange, the I-290 will not be filed and no withholding payment will be made.

If the seller does not use all of his exchange proceeds, at the end of the exchange period, the QI will return the balance of exchange funds to the seller, but must deduct the withholding amount from the exchange funds prior to returning them to the seller. It is important to note that if the seller does not provide the QI with a completed I-295, the QI has no choice but to withhold based on the gain realized. If the taxpayer originally completed a Form I-295 reporting the realized gain, as if it were a taxable sale, and now realizes that he will only recognize a partial gain, most QIs will accept a revised I-295 to show the actual recognized gain. The QI will submit withholding based on the revised affidavit.

West Virginia Pursuant to W Va. Code § 11-21-71b, nonresident individuals or entities are subject to withholding upon the sale of West Virginia real property. The withholding amount is either 2.5 percent of the total payment or 6.5 percent of the estimated capital gain. The withholding must be paid to the "real estate reporting person" before the deed is recorded and must be remitted to the Tax Commissioner within 30 days after it is withheld. If the seller intends to defer tax under §1031, he may request an exemption from withholding by filing Form WV/NRAE (Application for Certificate of Full or Partial Exemption) with the State Tax Department no later than 21 days prior to the closing date.

All of the rules and exceptions described above show how cumbersome the nonresident withholding requirement can be, when the nonresident seller is effecting a §1031 exchange. It is incumbent upon the taxpayer to seek competent tax and legal advice from independent advisors in each state where his properties are located, to make sure he complies with these and other state-specific requirements; otherwise, he may encounter unexpected tax consequences at both the state and federal level. Early communication among all the parties (the taxpayer, their advisors, attorneys, settlement agents and QI) as to any special state-specific rules will help eliminate confusion and misunderstanding in the transaction.

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