

MEMORANDUM

TO Ann Winborne; Richard H. Henninger

FROM Bruce P. Ely, Chair, Legislative Review Committee, Alabama State Bar
Section of Taxation; Committee Members

DATE June 26, 2008

SUBJECT New withholding requirements on sales of Alabama real property; some
practitioner comments and questions

As you know, effective August 1, 2008, Alabama will impose an income tax withholding requirement on the sale or transfer of real property and related tangible personal property in Alabama by seller who is a “nonresident of Alabama” (as specially defined). House Bill 357, now Acts of Ala. 2008-504 (the “Act”), generally requires that the buyer or transferee withhold and remit a certain percentage of the sale proceeds from a seller who is a “nonresident of Alabama” or transferor of Alabama real estate and related tangible personal property. Several other states have similar withholding provisions, including Georgia. The Alabama act appears to be almost identical to Georgia’s 1993 law. *See* Ga. Code Ann. § 48-7-128. To that end, we previously forwarded to you a copy of the Georgia DOR regulations and related forms.

This memorandum summarizes the Act’s withholding requirements and exceptions, and lists several related concerns and questions of interpretation raised by real estate and tax practitioners from several law firms, from Huntsville to Mobile. Following your review of their concerns and questions, it may be useful to arrange a meeting in Montgomery to let them explain those concerns and to discuss to what extent those concerns, if you agree with them, can be addressed by regulation or form, and to what extent a technical corrections bill may be necessary. We sincerely appreciate your interest in seeking our collective comments and questions.

I. Definition of “Nonresident” and Withholding Mechanics

The Act applies to sales of Alabama real property (and related tangible personal property) by seller who is a “nonresident of Alabama”, including individuals and entities. Obviously, the intent of the Act is to ensure that individuals and entities deriving income from sales of Alabama real estate report and pay taxes to Alabama on this income. Ala. Code § 40-18-2(a)(6); Ala. Code § 40-27-1, Art. IV, ¶ 6. By default, the Act appears to assume that all sellers are “nonresidents of Alabama” unless they provide the buyer or transferee with a signed affidavit affirming that the following four conditions have been satisfied (in which case the seller will be “deemed” to be a resident of Alabama):

- (1) The seller or transferor has filed Alabama income tax returns for the two preceding tax years (or requested extensions);
- (2) The seller or transferor is presently in business in Alabama and will continue conducting substantially the same business in Alabama; or, in the alternative, the seller or transferor will continue to own Alabama real property of greater or equal value than the withholding tax liability after the sale;
- (3) The seller or transferor will report the sale on an Alabama income tax return for the current taxable year and file said return by its due date; and
- (4) With respect to corporate or limited partnership sellers or transferors (only), the entity is registered to do business in Alabama (for example, LLCs are not included).

Assuming the seller or transferor can provide an affidavit that complies with the four requirements above, *i.e.*, qualifying as a “resident,” the buyer or transferee will not be required to withhold under the Act.¹ The Act’s definition of resident seller is identical to Georgia’s definition. *See* Ga. Code Ann. § 48-7-128.

If the seller cannot meet the above definition of a “deemed resident,” an individual buyer or transferee must withhold from the purchase price, and remit to the Alabama Department of Revenue (the “Department” or “ADOR”), a withholding tax equal to 3 percent of the purchase price (or total consideration paid for the property). A corporation, partnership, or unincorporated association (*e.g.*, LLC) that purchases or acquires Alabama property must remit to the Department a withholding tax equal to 4 percent of the purchase price (or total consideration paid for the property). The Act does provide for an alternative withholding tax base attributable to the taxable gain recognized on the transfer. A “nonresident of Alabama” seller may provide the buyer with a signed affidavit regarding the amount of gain to be recognized by the seller on the transaction, and the relevant withholding tax rate will be applied to this amount. If the amount required to be withheld and remitted, however, exceeds the net proceeds payable to the seller, then the buyer shall remit only the net proceeds otherwise payable to the seller to the Department.

Withholding Forms and Due Dates: The Act charges the Department with the task of drafting appropriate forms to accomplish its purposes, and provides that the withholding tax liability shall be assessed and collected in the same manner as all other withholding taxes imposed by the Alabama income tax code. The buyer or transferee must file the required return and remit payment to the Department by the last day of the next calendar month following the month in which the property transfer occurred.

II. Exceptions to the Withholding Obligation

¹ It is not clear whether the four conditions are satisfied if one or more condition is not applicable. One would assume, however, non-applicability would be tantamount to meeting the condition, but the statute is ambiguous in this regard.

Besides sales by Alabama residents (as defined by the above four requirements), the Act provides the following exceptions, virtually identical to Georgia's statute, where withholding by a buyer who purchases property from a nonresident seller is not required:

(1) *Personal residence* – The subject property is the principal residence of the seller or transferor, within the meaning of section 121 of the Internal Revenue Code;

(2) *Foreclosure action* – The seller or transferor is a borrower conveying the mortgaged property to the lender in either a foreclosure or a transfer in lieu of foreclosure with no additional consideration;

(3) *Exempt entities* – Either the buyer or the seller is an agent or authority of the U.S. or State of Alabama, the Federal National Mortgage Association, the Federal Home Loan Mortgage Association, the Government National Mortgage Association, or a private mortgage insurance company

(4) *Composite return for S corporation, partnership, LLC* – if the seller or transferor certifies to the buyer or transferee that a composite return is being filed with the Department by an entity and that the partnership, S corporation, or unincorporated organization remits the income tax attributable to the seller's or transferor's gain recognized on the transfer, on behalf of the nonresident partners, shareholders, or members. Any false certification regarding composite returns results in a penalty equal to the greater of \$500 or 10% of the withholding tax liability.

(5) *Exempt threshold to be promulgated by the Department* – The Act grants the Department the authority to set a minimum purchase price amount that would not be subject to the withholding requirements. For example, Georgia's withholding requirements do not apply to real property transfers with a sales price less than \$20,000 or a recognized gain of less than \$600. Ga. Comp. R. & Regs. § 560-7-8-.35

III. Questions/Concerns

- Which withholding rate applies to trusts? Is a trust an “unincorporated association”? Should there be a distinction between REITs, grantor trusts, business trusts, etc.?
- Does the alternative “taxable gain” withholding base allow the buyer to avoid liability if the seller recognizes a loss on the transfer? This is not clear from the statute.
- What about installment sales? Like-kind exchanges? This lack of clarity will result in significant hardship and/or uncertainty for like-kind exchange planning.
- What about an LLC or business trust that is “registered” to do business (or more accurately, “qualified to transact business”) in Alabama? Only corporations and limited partnerships are listed; however, the menu of available entities is much greater than corporations and limited partnerships.
- Use of inconsistent/ambiguous terms, e.g., “unincorporated organization” and “unincorporated association”. Are these terms meant to be identical? If not, what is the difference?

- No specific reference to LLCs in the definition of “nonresident,” which is perhaps due to the fact that Georgia did not recognize LLCs in 1993, when their law was enacted. Nevertheless, there should, at a minimum, be an express, affirmative exception or exclusion stated for Alabama domiciliaries and entities organized under Alabama law.
- Why does the status of the seller trigger the tax, but the amount of the tax is determined by the status of the buyer?
- Along the same lines as the status issue mentioned above, since the withholding tax is the "personal liability" of the buyer, what happens if the affiant lies or makes a mistake? Does "personal liability" attach to the buyer, or the closing attorney, with their only recourse being a civil action against the seller?
- Burden on the closing attorney – even though the legal burden is on the buyer, it will be the closing attorney or agent who will have the practical responsibility of undertaking efforts to ensure compliance. In many closings, the closing attorney does not represent the buyer (or for that matter, the seller). It would be advisable for some guidance to be provided defining safe harbors to protect facilitators of closings from professional liability or tax liability under the Act. In addition, there will likely be uncertainty as to who the “closing attorney” is, without detailed guidance from the ADOR or other appropriate authority.
- From a real estate lending standpoint, and due to the fact that the Act is based on a fairly old 1993 Georgia law, a glaring inadequacy likely relates to the common use of single asset entities (“SAEs”) today. SAEs literally cannot comply with the Act as currently written. Since the sole purpose of a SAE is to own a single piece of mortgaged property, banks often require SAEs be the borrower in loan transactions. But since it won't own any property in Alabama after the sale, or continue in "substantially the same business," there is likely no way for a SAE to satisfy the statute and be a "resident" for purposes of the Act. There is an exception (possibly) with composite tax returns, but that just alleviates the burden on the buyer; the tax is still owed, but will be paid by the seller on behalf of its nonresident members, partners, etc. Given the default status of the seller (as a nonresident), all SAEs, even those organized in Alabama and under Alabama law, literally cannot qualify as a “resident” under the Act.
- Other states have enacted non-resident withholding statutes. Most of those acts are of more recent vintage than the 1993 Georgia statute. It would be advisable to refer to those other acts. Other acts specifically address most of the issues raised in this memorandum.
- It is not clear whether the ADOR has authority to promulgate rules similar to the authority apparently vested with the Georgia Department of Revenue, in connection with its guidance granting various exemptions and exceptions to the Georgia act.
- There are several terms used in the Act which do not appear to be terms normally used under Alabama law, such as “registered to do business” and “commissioner’s delegate.” Moreover, does a taxpayer “remit to the Commissioner of Revenue”? We believe that remittance should be to the ADOR.
- It is not clear whether the non-application of one of the elements of the four-part conditions for deemed resident status will nevertheless constitute “meeting” those “conditions” as contemplated by subsection (a).
- Do the terms “consideration paid” and “net proceeds payable to the seller” include non-monetary items such as purchase money indebtedness, debt forgiveness (outside of the mortgage foreclosure exception), barter elements, discounts, and rebates? Will

“consideration paid” and “net proceeds payable” include closing expenses the buyer agrees to pay in connection with closing?

- Subsection (b)(2) appears to suggest that there is no procedure for disputing the amount due to the ADOR (or, as the statute states, to the “commissioner or the commissioner’s delegate”), without first paying over to the ADOR the tax that is demanded. This may be appropriate if a return is filed and the tax recited thereon is not duly paid; however, this seems inappropriate where the ADOR disagrees with the amount due as set forth on the form or where the buyer believed the transaction was exempt from withholding (to name a couple of examples).
- What about a taxpayer, aged 65 or older, living in Alabama for many years, but who has not filed (and is not required to file) Alabama income tax returns in the past few years because he or she has little income or “business” in Alabama—and they sell the lot next door to their residence? If there is no taxable gain on the sale, he or she may not have to file an income tax return that year. Under the Act, the Commissioner may set a threshold for minimum sales price but not minimum gain. The resident is deemed to be a non-resident for this purpose and withholding may be required.
- Can churches and other exempt (from income tax) charitable organizations be exempted if they are the seller?

Thank you again for your consideration and desire for input from the practitioner community. We look forward to hearing from you.

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