Lost Estate Tax Revenue

In “Estates and Trusts: No Relief For California,” in the September 2001 California Taxletter, we discussed that, to recoup lost revenue from estate tax changes, states might choose to raise other taxes or to enact a state death tax in the form of an estate tax, a gift tax, an inheritance tax, or a combination.

Proposition 6, passed by voters in the 1982 election, prohibits the California Legislature from enacting a gift or inheritance tax; the only estate tax that the Legislature can levy is equal to the permitted federal estate tax credit for state taxes (pick-up tax). Thus, the Legislature will have to find another way to make up for lost state revenue.

Nonresident Real Estate Withholding

Sellers may reduce or eliminate withholding

Buyers of California real property from nonresident sellers must withhold California tax from the sales proceeds at a rate of 3-1/3 percent of the sales price (R&TC Sec. 18662). If you have clients who are out-of-state sellers of California property, you can often assist them in eliminating or substantially reducing the withholding by filing for an exception or a waiver.

Escrow companies must notify buyers of their withholding requirements and normally assist in the withholding. Buyers must withhold an amount equal to 3-1/3 percent of the sales price in a disposition by one of the following:

- An individual seller:
  - With a last known street address outside California;
- Who the buyer learns is moving out of state; or
- Where the disbursement instructions authorize proceeds to be sent to a financial intermediary of the seller.

A corporate seller that has no permanent place of business in California, defined as a corporation that immediately after the sale is not:

- Organized and existing under California law;
- Qualified with the Secretary of State to do business in California; and
- Maintaining and staffing a permanent office in the state.

An irrevocable trust, unless one of the trustees is a California resident. Grantor trusts will usually be treated as if they are individuals.

An estate, unless the estate certifies that the decedent was a California resident at the time of death.

There is no withholding required for partnerships and LLCs because they are subject to withholding under R&TC Sec. 18662 on all distributions to nonresident partners/members (for more information, see the September 2001 issue of the California Taxletter).

Exceptions

There are numerous exceptions to the withholding requirement if the seller is a nonresident. A seller may complete Form 597-W, Withholding Exemption Certificate and Nonresident Waiver Request for Real Estate Sales, and be exempt from withholding if:

- The sales price does not exceed $100,000 (if multiple lots are sold at one time to one buyer, the amounts are aggregated).
- The property is the seller’s “principal residence” within the meaning of IRC Sec. 121.
- The seller is a bank acting as a trustee other than a trustee of a deed of trust or certain judicial foreclosures.
- The seller is a bank, acting as a fiduciary for a trust, or the seller is an IRA or a qualified pension/profit sharing plan.

Sellers must furnish buyers with a signed copy of FTB Form 597-W for an exception to apply.
Use Current Forms

There has been confusion among some escrow companies that use outdated forms. Under prior law, gain on the sale of principal residence depended on purchase of a new residence or the age of the taxpayer, and the forms reflected this requirement. However, since the change, the FTB has updated the forms. If the escrow company’s Form 597-W is not dated Rev. 2000 or later, you should demand that they obtain the proper form.

Waivers

The FTB has the authority to grant a waiver, which will reduce or eliminate the withholding. Generally, the FTB will require withholding on the projected gain at the maximum tax rate for the seller’s entity type (e.g., individual or corporate).

Sellers must submit Form 597-W to the FTB to request a waiver. A seller can obtain a waiver by filing Form 597-E, Nonresident Withholding

Exchange Affidavit, if the seller qualifies for non-recognition treatment under the like-kind exchange provisions of IRC Sec. 1031.

A seller should request a waiver in the case of installment sales using Form 597-I, Nonresident Withholding Installment Sale Agreement. If the seller does not request Form 597-I, the entire sales price is used to determine withholding, rather than the amount of each installment.

Taxpayers should fax the waiver to expedite processing. Documents to include with waiver requests are:

- An estimated closing statement.
- Documents to prove the original cost, such as the grant deed and the original purchase statement.
- Depreciation schedules and schedules of improvements.
- For an IRC Sec.1031 like-kind exchange, an estimated closing statement for the current transfer as well as a copy of a completed IRS Form 8824, Like-Kind Exchanges, or copies of the original purchase statements.
- For property acquired by inheritance, an estimated closing statement, a death certificate, IRS Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return (including documents supporting the value at date of death or alternative valuation date), and a copy of the trust if the property passed by trust.
- If acquired by death of a joint tenant, a copy of the death certificate, any applicable probate documents, IRS Form 706 and a copy of the original purchase statement.

Example of Calculation to Reduce Withholding

Winnie S. Cousin, a resident of Green Bay, Wisconsin, decided to sell her vacation property in Palm Springs, California. Winnie had paid $200,000 for the property, and sold it for $250,000. The statutory amount that is required to be withheld from the sale is $8,325 ($250,000 x 3.33% withholding rate). However, Winnie’s estimated California tax due from the sale is only $4,650 ($50,000 x 9.3% maximum tax rate). If Winnie requests a waiver, the FTB will reduce her withholding to $4,650, the amount of her estimated tax liability.

Selling price .................. $250,000
Withholding rate .................. 3.33%
Withholding amount ............ $8,325
Gain on sale .................. $50,000
Maximum tax rate .................. 9.3%
Estimated tax liability ............. $4,650

FTB decisions on waivers

The FTB will usually make its determination within 21 business days from the receipt of the waiver request. If all supporting documentation is included, they will generally complete routine applications within three business days.

If the sale is completed before notification by the FTB, the escrow person must withhold the statutory 3-1/3 percent, but may hold the funds in a trust pending receipt of the FTB’s decision on the waiver.
Determining the proper withholding for multiple sellers

The statute requires withholding on the entire sales price if one of the sellers is a nonresident. However, the FTB will allow the withholding to be prorated based on the nonresident seller’s percentage of ownership, as long as a waiver is filed and adequate proof of the percentage of ownership is provided. If a husband and wife are selling and one of them is a nonresident, the FTB requires full withholding unless they obtain a waiver.

Similarly, if a nonresident is on title only for incidental purposes, such as if a nonresident parent cosigned on the purchase in order to obtain a loan, the seller must request a waiver to avoid withholding on the entire sales price.

Cash-poor transactions

If there is not enough money in the sale to pay the withholding, the law still requires withholding. The FTB will not grant a waiver simply because there is inadequate cash. The FTB states that if the funds in escrow will not cover the withholding, “the parties must arrange to pay the withholding.” What can the buyer do if the seller refuses to put up the money? From a practical standpoint, the buyer may decide whether to pay the withholding or elect to pay the failure-to-withhold penalty, assuming the escrow person will complete the transaction without payment of the funds.

Nonresident aliens

The IRS requires buyers to withhold tax from property sold by nonresident aliens at a rate of 10 percent (IRC Sec. 1445). California’s 3-1/3 percent withholding requirement applies to both foreign and domestic nonresidents of California.

Penalty provisions

The penalty for failure to properly withhold is the greater of $500 or 10 percent of the amount required to be withheld. The FTB will withdraw the penalty if the buyer can show that the failure to withhold was due to reasonable cause.

The penalty for a seller who files a false exemption certificate is the greater of $1,000 or 20 percent of the amount required to be withheld.

The penalty imposed on an escrow person for failing to provide notice to the seller is the greater of $500 or 10 percent of the amount required to be withheld.

Due dates

Amounts withheld are due by the twentieth day of the month following the date title is transferred; in the case of the FTB acting on a waiver request, the twentieth day of the month following the end of the 45 days when no answer is provided. Form 597, Copy A, should accompany the payment. The FTB will charge interest on late payments.

Seller’s tax return

Withholding does not relieve the seller from filing a California tax return. It is simply a prepayment of the current year’s tax. Thus, it can be refunded if overpaid or additional amounts may be due if underpaid. If the amount is overpaid, the only way to have it refunded is to file a return for the year. There is no procedure for an early refund.

For more information, contact FTB’s Nonresident Withholding Section automated telephone service:

Phone: (916) 845-4900
U.S. toll free at: 1-888-792-4900
Fax: FTB (800) 998-3676