

A NEW REQUIREMENT TO LOAN THE STATE SOME MONEY

An Article by William A. Taylor One of the Business Lawyers

With sly, Cheshire cat-type grins, tax lawyers and tax accountants have quietly greeted a recently passed California tax law that will negatively affect the cash that is disbursed from real estate escrows. The new law should have the effect of driving sellers into the waiting arms of lawyers and accountants who create partnerships, corporations and limited liability companies (LLCs). However, sales of personal residences, and (1031) like-kind exchanges will be exempt.

3.33% Will Get You \$500. Commencing January 1, 2003, real estate escrow companies will be required to reserve a part of a seller's escrow proceeds, in the amount of 3.33% of the gross sales price, to be forwarded to the state Franchise Tax Board to pay the anticipated income tax on the transaction. Additionally, if there is not enough money in the transaction to pay the tax and close the escrow, the difference must be made up by either the buyer or the seller. If an escrow company fails in this requirement to deduct, the penalty on that escrow company will be 10% of the amount that should have been withheld or \$500 - whichever is greater. In transactions without escrow companies, the buyers are saddled with the same reserve requirements as escrow companies.

In plain language, the new law means that a seller will have state income tax payments deducted from the escrow proceeds by an escrow agent who is following the dictates of a new law. An example would be the January 12, 2003 sale of California real estate at a gross sales price of \$400,000, 3.33% of which would be \$13,320 - the amount to be withheld from the escrow and forwarded to the state of California. If the tax basis numbers and gain calculation cause the tax to actually be less than the \$13,320, the state will pay the seller a refund of the excess tax withheld - after the tax return for 2003 is filed the next year - in March or April of 2004.

Non-Human Exemptions from Withholding. The requirement to withhold applies for sellers who are individuals - human beings. The requirement does not apply to sellers that are corporations permanently doing business in California. The requirement does not apply with sellers that are general partnerships or LLCs. The requirement does not apply with sellers that are probate estates for California decedents; nor does it apply to irrevocable trusts with California trustees. All of these sellers will be required to sign California Franchise Tax Board form 593-W to certify, under penalty of perjury, that the seller qualifies for exemption from the withholding. Otherwise, the sales proceeds from escrow will be 3.33% lighter.

Create an LLC or a Corp for the Sale Transaction. Breathing new life in those lawyers and accountants who advise on and form LLCs and corporations, the new law will force a number of sellers into the embrace of these professionals for the creation of a non-human entity to perform the sale in the place of humans. If the same property were contributed to an LLC or a corporation or an irrevocable trust, or even a general partnership, that change of property title to a non-human will eliminate the withholding requirement and the 3.33% cash withholding.

Human Exemptions from Withholding. If you sell your principal residence, there is an exemption. Internal Revenue Code section 1031 exchanges (like-kind) are also exempt, as well as involuntary conversions (IRC 1033). Additionally, a gross sales price of \$100,000 or less will exempt the

transaction. Installment sale payments are exempt if the underlying transaction occurred prior to 2003. Finally, if the seller can prove a loss, no withholding will be required. To register for the exemption, humans will file FTB form 593-C. Filing a false exemption certificate will net a penalty of \$1,000 or 20% of the amount required to be withheld - whichever is greater.

The California Revenue and Taxation code sections that are responsible for all of this shifting of money are sections 18662(e), 18668 and 19183.

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