Why Short Sales Create a Cash Problem when there is FIRPTA Withholding

A short sale happens when a lender agrees to accept less than the outstanding mortgage balance, letting an owner sell instead of going through foreclosure. That negotiation is stressful enough on its own. It gets more complicated when the seller is a foreign person, because of the Foreign Investment in Real Property Tax Act (FIRPTA).

FIRPTA requires the buyer to withhold 15% of the *gross sales price*, not the profit or net proceeds, and send it to the IRS. In an ordinary sale, that withholding comes out of the seller's proceeds at closing. In a short sale, there typically are no proceeds. The sale price doesn't even cover the mortgage. Some sellers have to bring cash to the closing table just to satisfy the lender, and FIRPTA's 15% withholding sits on top of that.

There is no automatic short-sale exception to FIRPTA withholding. The rules that apply are the same ones that apply to any sale by a foreign person, though there are a couple options can reduce or eliminate FIRPTA withholding.

- **Option 1: Personal Residence Exception**:
  - sales price of $300,000 or less where the buyer signs an affidavit stating their intent to occupy the home for at least 50% of the time it is used during the first two 12-month periods
  - sales price between $300,001 and $1,000,000 and a buyer's affidavit stating personal residence intent. This changes the withholding requirement from 15% to 10%.
- **Option 2: IRS Withholding Certificate**: an application to the IRS to support the calculation of the actual tax liability and receipt of a formal letter from the IRS reducing or eliminating withholding because the actual tax liability is lower than the required percentage.

Option 1: The Personal Residence Exception

The IRS has a defined exception that eliminates withholding entirely, regardless of who the seller is or why they're selling. According to the IRS's Exceptions from FIRPTA withholding page, no withholding is required if:

1. The buyer is acquiring the property to use as a **residence**, and
2. The buyer, or a family member, has definite plans to live at the property for **at least 50% of the days** the property is used by anyone during each of the first two 12-month periods after the sale, and
3. Sale price
   - The amount realized (generally the sales price) is **$300,000 or less** then the sale meets the exception and FIRPTA withholding is not required
   - The amount realized (generally the sales price) is **between $300,001 and $1,000,000** then required withholding is reduced to 10% (from 15%).

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This exception applies only to individual buyers, not corporations or other entities, and only counts occupied days. Days the property is vacant days aren't counted against the 50% threshold. Land without a residence does not qualify, even if there is intent to build a residence by the buyer.

Above $1,000,000, the full 15% applies no matter how the buyer intends to use the property.

If your short sale fits the $300,000-or-less exception, no withholding is required and the closing can proceed as scheduled.

Option 2: Apply for a Reduced Withholding Certificate

Many short-sale sellers are in a strong position to reduce their withholding through a different mechanism if they are selling for a loss. If a seller's actual tax liability on the sale is expected to be little or nothing, as is often the case with a short sale, the IRS allows an application to reduce the withholding to match that lower amount.

An application for reduced withholding can be used to apply for a withholding certificate to reduce or eliminate withholding on dispositions of U.S. real property interests by foreign persons.

A few practical points matter here:

- **Timing.** The application should be submitted as early as possible, but no later than the date of closing. The IRS states it will generally act on withholding certificate requests within 90 days after receiving a complete application. All parties to the transaction must have a U.S. tax identification number in order to apply for reduced withholding.
- **What "complete" means.** The application needs to include estimated numbers supporting why the tax owed will be less than the standard withholding amount. In a short sale where the seller is losing money on the property, this is often straightforward to demonstrate.
- **What happens while you wait.** If the certificate hasn't been issued by the closing date, the closing itself doesn't have to wait — but the withholding still needs to be addressed, typically by having the closing agent hold the funds in escrow until the IRS responds, rather than remitting the full amount immediately.
- **Not a guarantee.** Submitting Form 8288-B doesn't guarantee approval or a specific dollar reduction. The IRS reviews the numbers submitted and determines the appropriate withholding amount based on the actual facts of the sale.

What This Means for Sellers and Their Advisors

Neither of these options is automatic.

Because a short sale already involves lender negotiations, appraisal issues, and tight timelines, adding a FIRPTA withholding question late in the process is one of the more common ways these deals stall or fall apart at the closing

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table. The more proactively this is addressed, ideally as soon as a short sale is under consideration the better able a taxpayer is to be able to plan and get the best result.

Key Takeaways

- FIRPTA requires 15% withholding on the gross sales price when a foreign person sells U.S. real estate, and there is no special exception for short sales.
- A sale of $300,000 or less to a buyer who will occupy the property as a residence (residence-buyer) for at least half the time over the next two years can qualify for zero withholding.
- Sales between $300,001 and $1,000,000 to a residence-buyer qualify for a reduced 10% rate instead of 15%.
- If neither exception fits, a foreign seller can apply for a withholding certificate to reduce withholding to match the actual expected tax.
- The IRS generally takes about 90 days to act on a complete withholding certificate application, so timing the submission early is critical to avoiding delays at closing or delays in having proceeds released.

Conclusion

A short sale is difficult enough without an unexpected 15% withholding requirement on top of an already difficult transaction. The good news is that FIRPTA's rules, while strict, do leave room to address this. The seller's tax outcome, and the buyer's timeline, both benefit from addressing this question as early in the process as possible.
If you're a foreign national navigating a short sale, or a real estate professional working with one, it's worth talking to a tax advisor experienced in FIRPTA before a contract is signed.
We are glad to assist foreign sellers and their professional advisors with the filing of a withholding certificate application or any questions there might be regarding the process.

Author's Note

This article is for informational purposes only and does not constitute legal or tax advice.

Cross border transactions present unique complexities. Each situation involves a different face pattern and each is unique. Small changes in fact pattern can have very different tax results. Your intended goals, property values, ownership structures, gain calculations, timing, risk tolerance, and fact pattern considerations all affect the strategy that is right for you.

Consulting with tax professionals who regularly handle international property transactions helps ensure you understand your specific obligations and exploring available options that can help you maximize your profits and minimize tax and compliance costs. Consult a qualified tax professional regarding your specific situation.

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