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## California Withholding on the Sale of Real Property

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December 8, 2004 (revised)

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### Table of Contents

- I. Introduction**
- II. California Rule**
  - A. The Basics**
  - B. Withholding Certificate/Waiver**
  - C. Handling of Funds and Reporting**
  - D. Fee**
  - E. Potential Liability**
  - F. Seller's Affidavit**
  - G. The Purchase Contract**
  - H. California Tax Forms and Publications**
  - I. Additional Information**

### I. Introduction

This memorandum discusses the requirement under California law that a buyer withhold and transmit to the Franchise Tax Board (FTB) funds equal to 3 1/3 percent of the sales price of California real property unless an exemption applies.

Effective January 1, 2005:

- A buyer will be required to withhold 3 1/3 percent of the gross sales price from both individuals ("natural persons") and non-individuals selling real property, unless a certifiable exemption applies.
- The certifiable exemptions include:
  - the sale of property for less than \$100,000,
  - for individuals, the sale of a principal residence or a property last used as a principal residence,
  - the sale of a decedent's principal residence by a trust or estate,
  - the sale of property by a corporation with a permanent place of business in California,
  - an Internal Revenue Code ("IRC") §1031 exchange,
  - an involuntary conversion under IRC §1033, and
  - the sale of property at a loss for California income tax purposes.

The Questions and Answers that follow are based mainly on California Revenue and Taxation Code ("Rev. & Tax Code") §§18662 and 18668, as amended by AB 1388. The Questions and Answers are necessarily general in nature, and are not intended to cover every fact situation. Slightly different facts may produce different results. Accordingly, parties should consult a professional tax advisor to determine whether (and how much) withholding is required in a particular transaction.

As used in this memorandum, "seller" means any transferor, and "buyer" means any transferee, unless specified differently in the California withholding law.

## II. California Rule

### A. The "Basics"

#### Q 1. *When do the new withholding laws go into effect?*

A. The new withholding requirements go into effect on January 1, 2005 and require withholding on any disposition of real property that closes on or after that date unless an exemption applies. Prior to January 1, 2005, withholding is also required but the exemptions to withholding differ depending on whether the seller is an individual or a non-individual.

#### Q 2. *What is required under the California law for withholding on the sale of California real property?*

A. Buyers must withhold 3 1/3 percent of the gross sales price on sales of California real property interests, unless an exemption applies.

#### Q 3. *What sales are covered under this law?*

A. The statute states that there must be withholding on any disposition of a California real property interest (Rev. & Tax Code §§18662(e)). This includes sales, exchanges, installment sales, and other types of transfers.

#### Q 4. *What are the exemptions to this law?*

A. After January 1, 2005, no withholding is required when any one of the following exemptions applies:

#### **FOR ALL SALES:**

- The sales price of the property does not exceed \$100,000;
- The buyer does not receive written notification of the withholding requirement from the "real estate escrow person";
- The property is acquired under a deed of trust or mortgage through judicial or nonjudicial foreclosure or by a deed in lieu of foreclosure;
- Sales by a bank acting as a trustee other than under a deed of trust; or
- The seller is a partnership, LLC, tax exempt entity, insurance company, IRA or qualified pension plan.

#### **FOR INDIVIDUALS AND CORPORATIONS WITH A PERMANENT PLACE OF BUSINESS IN CALIFORNIA:**

- The seller signs an affidavit under penalty of perjury stating
  - that the property is the seller's principal residence within the meaning of IRC §121 (i.e. the seller has owned and used the property as a principal residence for two out of the last five years); or
  - that the property was last used as the seller's principal residence within the meaning of IRC §121 (this applies even though the seller may not have owned and used the property as a principal residence for two out of the last five years); or
  - that the seller is a corporation with a permanent place of business in California (a corporation does not have a permanent place of business in California if all of the following apply: (1) it is not a California corporation, (2) it does not qualify with the California Secretary of State to transact business in California, and (3) it does not maintain and staff a permanent office in California).

#### **FOR ALL OTHER INDIVIDUALS, CORPORATIONS WITHOUT A PERMANENT PLACE OF BUSINESS IN CALIFORNIA, AND TRUSTS AND ESTATES:**

- The seller signs an affidavit under penalty of perjury stating that
  - the property was the decedent's principal residence within the meaning of IRC §121; or
  - the sale is part of an IRC §1031 exchange (but only to the extent of the amount of gain not required to be recognized for California income tax purposes under IRC §1031); or
  - the property has been involuntarily or compulsorily converted and the seller intends to acquire property similar or related in service or use in order to be eligible for nonrecognition of gain for California income tax purposes under IRC §1033; or
  - the transaction will result in a loss for California income tax purposes.

(Rev. & Tax Code §§18662 and 18668)

Note that trustees of revocable or "living trusts" are treated as "individuals" for purposes of withholding.

The buyer should retain a copy of the seller's affidavit for their records.

#### Q 5. *Is withholding required when a partnership or limited liability company (LLC) sells California real*

**property?**

**A.** No withholding is required if the title to the real property was recorded in the name of a partnership or LLC. However, partnerships and LLC's are subject to separate withholding requirements. See FTB Publication 1017 for more information on this subject. See Question 30 for how to obtain FTB publications.

**Q 6. Is withholding required if there are one or more owners/sellers meeting an exemption and other owners/sellers who do not?**

**A.** Yes. However, withholding is required only to the extent of each seller's interest in the property if they are unable to qualify for an exemption.

**Q 7. Is withholding required if the sale is part of an exchange as defined under Internal Revenue Code §1031?**

**A.** As noted above, there is an exemption if the seller signs an affidavit stating that the transaction is part of a §1031 exchange.

**Q 8. What are the withholding rules when a relocation company participates in a sale?**

**A.** Sales involving relocation companies are subject to the same rules as other sales. (FTB Pub. 1016).

**Q 9. Is withholding required on installment sales?**

**A.** Yes. However, withholding on the full sales price can be deferred if the buyer agrees to withhold 3 1/3 percent of the down payment and each payment thereafter (Rev. & Tax Code §18662).

**Q 10. Is withholding required in a cash-poor transaction such as a short sale, or when the buyer puts little or no money down?**

**A.** Yes. The fact that a transaction is cash-poor is not an exception to withholding. If the property is being sold at a loss, sellers can sign an affidavit stating that the property is being sold at a loss.

**Q 11. Is withholding required on a sale by a California trust?**

**A.** Yes unless an exemption applies. Perhaps the most used exemption will be when the trustee signs an affidavit certifying that the sale is of a decedent's principal residence within the meaning of IRC § 121.

**Q 12. Is withholding required on a sale by an estate?**

**A.** No withholding is required if the executor/executrix signs an affidavit certifying that the sale is of a decedent's principal residence within the meaning of IRC § 121.

**Q 13. Is withholding required when foreclosing?**

**A.** Withholding is automatically waived if the property is being acquired under a deed of trust or mortgage through a judicial or non-judicial foreclosure or by a deed of trust in lieu of foreclosure.

**Q 14. Is withholding required on sales by tax exempt entities, insurance companies or the Resolution Trust Corporation (RTC) or other federal, state, or local government agencies?**

**A.** No. Under current FTB regulations, because these sellers are exempt from income tax (insurance companies are subject to a gross premiums tax and not income tax), they are, accordingly, exempt from withholding. The current FTB approach is that the buyer can rely on a written statement from a tax-exempt entity or insurance company. No statement is required from the RTC or other governmental agency. It is anticipated that the FTB will continue to recognize this exemption. (FTB Pub. 1016)

**Q 15. Who is responsible for the withholding?**

**A.** The buyer is responsible for withholding the required amount. (Rev. & Tax Code §§18662) This is typically accomplished through a written instruction to escrow. If there are two or more buyers, each is obligated to withhold. However, the obligation of all of the buyers will be met as long as at least one of them withholds and transmits to the FTB the required amount. (FTB Pub. 1016)

**Q 16. Who is responsible for notifying the buyer of the withholding requirement?**

**A.** It is the responsibility of the "real estate escrow person" to notify the buyer in writing of the withholding requirement. (Rev. & Tax Code §§18662(e))

**Q 17. Who is a "real estate escrow person"?**

**A.** A real estate escrow person is any of the following persons involved in a real estate transaction in the following order of priority:

- The person responsible for closing the transaction (typically an escrow company, title company, or attorney),
- Any other person who receives and disburses the funds paid or other consideration or value given for the property conveyed.

(Rev. & Tax Code §§18662(e)(6))

## **B. Withholding Waiver**

### **Q 18. Can the seller request a reduced amount (or no amount) of withholding?**

**A.** Effective January 1, 2005, sellers can no longer request that the FTB authorize a reduced amount of withholding. However, both individuals and non-individuals can certify that they meet one of the applicable exemptions.

## **C. Handling of Funds and Reporting**

### **Q 19. When must the required amount of withheld funds be sent to the FTB?**

**A.** The required amount withheld must be remitted to the FTB within 20 days following the end of the month in which the transaction closes. (FTB Pub. 1016) For example: If title transfers to the buyer on March 15, 2005, the buyer must remit the required amount and form to the FTB by April 20, 2005. Again, the parties should usually instruct the escrow holder to perform this function.

### **Q 20. How are withheld amounts reported and transmitted?**

**A.** They are reported and transmitted on California tax form 597. See Question 30 for how to obtain California tax forms. The form and the withheld amount should be sent to:

Franchise Tax Board  
P.O. Box 942867  
Sacramento, California 94267-0001

In addition, if there are multiple sellers, the applicable form must be filed for each person subject to withholding.

NOTE: Currently, Copy B of California Form 597 must be attached to the face of the seller's tax return, so that the withheld amount will be credited against the seller's FTB tax obligations. (FTB Pub. 1016)

## **D. Fee**

### **Q 21. Can escrow companies charge a fee for this service?**

**A.** Escrow may not charge a fee to notify the buyer of the withholding requirement. Escrow may charge a fee only if it withholds and remits money to the FTB or assists the parties in dealing with the FTB. In this instance, the fee may not exceed \$45.00. (Rev. & Tax Code §§18662(e)(7)(D))

## **E. Potential Liability**

### **Q 22. What is the potential liability of the buyer for failure to withhold the required amount when given written notification of the withholding requirement by the escrow holder?**

**A.** The FTB can assess the buyer the full 3 1/3 percent of the sales price that should have been withheld, or the seller's actual tax liability in the sale, not in excess of 3 1/3 percent, whichever is greater, unless the failure to withhold is due to reasonable cause.

Even if the seller eventually pays the taxes due on the sale, the buyer can still be held liable for a penalty for failing to withhold as required.

This penalty is the greater of:

- \$500.00, or
- 10 percent of the amount required to be withheld, plus interest and collection costs.

(Rev. & Tax Code §18668(d))

### **Q 23. Are there any exemptions to the penalty mentioned above?**

**A.** Yes, there are two exemptions. The buyer is not liable if the failure to withhold was either:

- the result of the real estate escrow holder's reliance upon the seller's affidavit as long as the reliance was in good faith and based on all the facts known to the escrow holder (Rev. & Tax Code §18668(e)(4)); or
- due to "reasonable cause." (Rev. & Tax Code §18668(d))

**Q 24. What is the potential liability of the escrow holder for failure to notify the buyer of the withholding requirements?**

**A.** When a California real property disposition is subject to withholding, failure of the escrow holder to give written notification of the withholding requirements subjects the escrow holder to a penalty of:

- \$500.00, or
- 10 percent of the amount required to be withheld, whichever is greater, unless the failure to notify is due to reasonable cause.

(Rev. & Tax Code §18668(d)(1))

**Q 25. Are there any situations in which the escrow holder is excused from the penalty mentioned above?**

**A.** Yes, the escrow holder is excused from the penalty if:

- the seller actually pays the tax due on the transfer;
- the failure to notify is based on "reasonable cause"; or
- the escrow holder relies on the seller's affidavit as long as the reliance is in good faith and based on all the facts known to the escrow holder.

(Rev. & Tax Code §§18668(e))

**Q 26. Is there any liability for a seller under this law?**

**A.** Yes. Any seller who knowingly files a false affidavit is liable for the greater of:

- \$1,000, or
- 20 percent of the amount required to be withheld.

(Rev. & Tax Code §18668(e)(5))

## **F. Seller's Affidavit**

**Q 27. What is the seller's affidavit?**

**A.** The seller's affidavit is a document used to obtain an exemption from withholding. In it, the seller certifies, under penalty of perjury, that he/she/it meets one of the withholding exemptions listed in Question 4. If the seller completes the California portion of that form and signs it, the buyer can rely on it without fear of any liability for not withholding, unless the buyer knows that information in the affidavit is false. (Rev. & Tax Code §18668(e))

**Q 28. Must the seller's affidavit be signed before a notary public?**

**A.** No.

## **G. The Purchase Contract**

**Q 29. What provision should be made in the sales agreement for compliance with this law?**

**A.** The deposit receipt or other sales agreement should reflect the agreement of the buyer and seller to comply with the requirements of this law by either having the proper amount of tax withheld and deducted through escrow, or obtaining and providing appropriate documentation that no withholding, or reduced withholding, is required.

C.A.R.'s California Residential Purchase Agreement and Joint Escrow Instructions (RPA-CA) covers compliance with this law under the paragraph entitled "Withholding Taxes." Parties to transactions who use other contract forms should include an appropriate provision in each agreement.

## **H. California Tax Forms And Publications**

**Q 30. Where can I obtain the California tax forms and publications referred to in this legal memorandum?**

**A.** You can get California tax forms and publications in several ways:

- 1) Through the FTB's website at <http://www.ftb.ca.gov/>.

- 2) By mail at Tax Forms Request Unit, Franchise Tax Board, P.O. Box 302, Rancho Cordova, CA 95741-0307.
- 3) By telephone from the FTB's Withholding Section at 800.792.4900 or 916.845.4900.
- 4) By fax at the FTB's Forms by Fax at 800.998.3676.

Note, however, that at the time of writing this legal memorandum, the FTB has not produced forms or publications implementing the amendments to the withholding law. The FTB anticipates that they will have forms available in mid-December 2004.

## I. Additional Information

### Q 31. *Where can I obtain additional information?*

A. Principals should consult their own professional tax advisors for advice in particular transactions.

In addition, the FTB has set up a special unit to deal with this law. You may contact this unit by telephone at 916.845.4900, by fax at 916.845.4831, through the FTB's website at [www.ftb.ca.gov](http://www.ftb.ca.gov), or write to

Franchise Tax Board  
Withholding at Source Unit  
P.O. Box 651  
Sacramento, CA 95812-0651.

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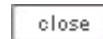
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The information contained herein is believed accurate as of December 8, 2004. It is intended to provide general answers to general questions and is not intended as a substitute for individual legal advice. Advice in specific situations may differ depending upon a wide variety of factors. Therefore, readers with specific legal questions should seek the advice of an attorney.



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