TAX FACTS

From the
State of Hawaii, Department of Taxation

October, 2010 | **UNDERSTANDING HARPTA** | **2010-1**

Note: All references to the IRC are to the Internal Revenue Code of 1986, as amended. All quoted IRC sections have been made operative for Hawaii income tax purposes.

The purpose of this Tax Facts is to provide guidance on the Department of Taxation's (Department) interpretation of Section 235-68, Hawaii Revised Statutes (HRS) entitled "Withholding of tax on the disposition of real property by nonresident persons" and which is commonly referred to as "HARPTA". As used herein, the person disposing of the real property interest is referred to as the "Transferor/seller" and the purchaser of the Hawaii real property interest is referred to as the "Transferee/buyer".

1. What is HARPTA?

HARPTA is patterned after the federal Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). Like FIRPTA, the intent of HARPTA is to insure compliance with Income Tax law by nonresidents. It does so by requiring the purchaser of real property in Hawaii to withhold up to 5% of the amount realized on the disposition of the real property by a nonresident person, and forwarding this amount (using Form N-288 "Hawaii Withholding Tax Return for Dispositions by Nonresident Persons of Hawaii Real Property Interests" and Form N-288A "Statement of Withholding on Dispositions by Nonresident Persons of Hawaii Real Property Interests") to the Department.

2. When does HARPTA apply?

HARPTA applies whenever real property located in Hawaii is transferred. A common misperception is that HARPTA does not apply under certain conditions, such as when the seller is a resident of Hawaii. In fact, HARPTA does apply, but the Transferee/buyer may be exempt from the withholding requirements of HARPTA. See Question No. 28 below. HARPTA requires that the Transferee/buyer obtain Form N-289 ("Certificate for Exemption from the Withholding Tax on the Dispositions by Nonresident Persons of Hawaii Real Property Interests") from the Transferor/seller attesting to such residency. If the Transferor/seller refuses to provide such certificate, the Transferee/buyer is required to withhold, even if the Transferee/buyer has personal knowledge that the seller is a Hawaii resident. If a certificate is provided but the Transferee/buyer knows that it is false, the Transferee/buyer is obligated to withhold.

Example 1:

Transferor/seller is a Hawaii resident but does not believe that he is obligated to file and pay Hawaii income taxes. Transferor/seller enters into a sales agreement to sell real property located in Hawaii to his brother, who knows that the Transferor/seller is a Hawaii resident, Transferor/seller refuses to provide the certificate required. The Transferee/buyer is required to withhold 5% of the amount realized, and if he fails to do so, is liable for the amount that should have been withheld, even though he knows that the Transferor/seller is a Hawaii resident. See also Question 8 below.

Example 2:

Transferor/seller is not a Hawaii resident but provides to the Transferee/buyer a certificate stating that he is a Hawaii resident, which the Transferee/buyer knows to be false. The Transferee/buyer is required to withhold 5% of the amount realized in spite of the fact that an affidavit has been provided, and failing to do so, is liable for the amount that should have been withheld.

3. What constitutes "real property"?

"Real property" is defined in HRS §231-1 and "includes all land and appurtenances thereof and the buildings, structures, fences, and improvements erected on or affixed to the land, and any fixture which is erected on or affixed to the land, buildings, structures, fences, and improvements, including all machinery and other mechanical or other allied equipment and the foundations thereof, whose use is necessary to the utility of the land, buildings, structures, fences, and improvements, or whose removal therefrom cannot be accomplished without substantial damage to the land, buildings, structures, fences, and improvements, excluding, however, any growing crops."

Example 1:

Owner purchases a central air conditioner and installs the unit in his personal residence. The unit cannot be removed without substantial damage to the home. The unit is considered to be part of the real property.

Example 2:

Owner purchases a window air conditioner and installs the unit in his personal residence. The unit can be removed without substantial damage to the home. The unit is not considered to be part of the real property, even if it is being sold as part of the transaction. See also Question 18 below.

4. Who is a "nonresident"?

A nonresident is any person (or entity) other than a resident person. A resident person is defined as:

(1) Individual domiciled in the State or who resides in the State for other than a temporary or transitory purpose. Domicile is the place of the individual's true, fixed, permanent home (*for more information on domicile and residency, see Tax Information Release No. 97-1, "Determination of Residence Status")*;
(2) Corporation incorporated or granted a certificate of authority under chapter 414, 414D, or 415A;
(3) Partnership formed or registered under chapter 425 or 425E;
(4) Foreign partnership qualified to transact business pursuant to chapter 425 or 425E;
(5) Limited liability company formed under chapter 428 or any foreign limited liability company registered under chapter 428, other than a single member limited liability company that has not elected to be taxed as a corporation;
(6) Limited liability partnership formed under chapter 425;
(7) Foreign limited liability partnership qualified to transact business under chapter 425;
(8) Trust where the trustee, or other fiduciary, is a resident of Hawaii or the administration of the trust is carried on in Hawaii; or
(9) Estate of a resident decedent if a Hawaii court appoints a personal representative or administrator to carry on the administration of the estate.

Thus, a nonresident is a person not domiciled in Hawaii and who has only a transitory presence in Hawaii, as well as any entity such as a corporation, partnership, limited liability company, trust or estate that is not domiciled in Hawaii and which is not qualified to transact business in Hawaii.

5. Is HARPTA a tax?

HARPTA is not a tax per se. Rather, the amount paid to the Department by the Transferee/buyer is an estimated tax payment made for the benefit of the Transferor/seller, taken out of monies otherwise due to the Transferor/seller. The Transferee/buyer is acting as a withholding agent. When the Transferor/seller files its Hawaii income tax return showing the amount of tax due as a result of the sale (as well as any other Hawaii sourced income), the amount of any taxes due is reduced by the amount of the HARPTA payment, as well as any other estimated tax payments made and amounts withheld at the source. In addition, any State tax credits that the Transferor/seller is entitled to may be applied to the outstanding tax due. If the amount paid (including allowable credits) exceeds the amount of the tax liability, the taxpayer/ Transferor/seller is entitled to a refund of the overpaid amount, unless the Transferor/seller chooses to apply some or all of the refund to future estimated tax payments. If a balance remains due, the Transferor/seller is responsible for paying the balance.

6. How much is collected under the HARPTA law?

If the Transferor/seller provides an exemption certificate to the Transferee/buyer, no amount is required to be withheld. Otherwise, the amount collected under the HARPTA law is a flat 5% of the amount realized, unless a withholding certificate has been obtained by the Transferor/seller which allows the Transferee/buyer to withhold a reduced amount.

7. The amount that was withheld on the sale is excessive. How can I pursue a refund earlier if I have no other Hawaii income items to report?

In the event the withholding under HARPTA is excessive, the Transferor/seller may apply for a tentative refund using Form N-288C "Application for Tentative Refund of Withholding of Tax on Dispositions by Nonresident Persons of Hawaii Real Property Interests". Even though the State approves and pays a tentative refund request, the Transferor/seller must still file a Hawaii income tax return for the year of transfer. Even if a tentative refund has been approved and paid, if the return as filed shows a tax due, the Transferor/seller must pay the tax.

8. Who is responsible for withholding the amounts, if required?

Generally, the Transferee/buyer must determine if the seller is a non-resident and is responsible for withholding the required amounts from the amounts to be paid over to the Transferor/seller. The Transferor/seller may provide to the Transferee/buyer a withholding certificate (Form N-288B "Application for Withholding Certificate for Dispositions by Nonresident Persons of Hawaii Real Property Interests") or an exemption certificate (Form N-289 "Certificate for Exemption from the Withholding Tax on the Dispositions by Nonresident Persons of Hawaii Real Property Interests") which may reduce or eliminate the amounts required to be withheld. See Questions 14 and 28 below for further information. The Transferee/buyer may be held liable for the tax that should have been withheld on the purchase if it fails to withhold required amounts.

9. When is the HARPTA payment due?

The Transferee/buyer must submit Forms N-288 and N-288A together with the withheld amounts to the Department not more than twenty days following the transfer date. Failure to file the return or to timely pay the amount due may result in the imposition of penalties and/or interest.

10. What is the transfer date?

The transfer date is the date on which the sale closes and title to the property passes from the Transferor/seller to the Transferee/buyer.

11. What is the "amount realized" and how is that different than the sales price?

Normally, the amount realized is the purchase/sales price of the Hawaii real property interest. However, the amount realized also includes the fair market value of property received (or to be received) by the Transferor/seller plus the amount of any liability assumed by the Transferee/buyer or to which the property is subject to, immediately before and after the transfer.

Example 1:

Seller and Buyer enter into a sales and purchase agreement, whereby Buyer purchases Seller's apartment building for $3,000 cash plus an assumption of a non-recourse mortgage secured by the apartment building in the amount of $1,500,000. The amount realized is $1,503,000.

Example 2:

Seller and Buyer enter into a sales and purchase agreement, whereby Buyer purchases Seller's home for $100,000 cash. In addition, the Buyer will transfer to Seller free and clear title in Buyer's property located in Austin, Texas having a fair market value of $200,000. The amount realized is $300,000.

12. What is a disposition?

A disposition means "disposition" for any purpose of the IRC. Most often, this is simply the normal sale/purchase agreements for real estate. However, many other transactions may also qualify as dispositions, including exchanges, liquidations, redemptions, gifts, transfers, capital contributions, etc. A disposition may occur even if the transaction results in no current recognition of gain or loss. For further information, please see Internal Revenue Service (IRS) Publication 544 ("Sales and Other Disposition of Assets").

13. Does HARPTA apply to "short sales" or to foreclosures?

HARPTA applies to all dispositions of real property located in Hawaii, regardless of how the transfer occurs. Dispositions can occur voluntarily through a warranty deed or grant deed (as when sold on the open marketplace), by consent (as through a short sale), or involuntarily (as through a foreclosure).

A short sale occurs when a lien holder and property owner agree to a transaction whereby the property is sold (whether to the lien holder or to a third party) for a price that is less than the outstanding mortgage balance. The excess of the mortgage balance over the sales price may or may not be forgiven depending on the agreement. If some or all of the deficiency is forgiven, the Transferor/seller may have cancellation of debt income, depending on the circumstances. See Question 25 below.

While HARPTA applies, there may be no withholding requirement under a foreclosure or a short sale, if the proceeds of sale are insufficient to pay all costs of sale and the lien holders in full. See Question 20 below. The Transferor/seller remains obligated to file a Hawaii income tax return for the year of disposition.

14. What if the Transferor/seller will not realize a gain on the disposition of the property?

If the Transferor/seller will not realize a gain on the transfer of the Hawaii property, the Transferor/seller may apply to the Department, using Form N-288B, for a withholding certificate that reduces or eliminates the amount to be withheld by the Transferee/buyer. The Transferor/seller should submit supporting documentation to show that there will be no realized gain. Such documentation may include:

- Closing statement when the property was purchased showing the purchase price;
- Documentation showing the depreciation allowed or allowable, if any;
- Documentation for any capital improvements and other increases in basis; and
- Documentation showing decreases to basis, including any deferred gain from any prior sale(s).

Form N-288B **must** be filed with the Department at least ten (10) working days prior to the date of transfer or it will not be approved. Although a withholding certificate may be granted by the Department based upon no realized gain on the transfer, the Transferor/seller is not relieved of the duty of filing a Hawaii income tax return for the year of disposition.

15. What kind of documentation is acceptable?

The best documentation the Transferor/seller can provide to the Department is copies of the original closing statements, contracts, purchase orders, and the like. For purposes of Form N-288B and N-288C, oral statements or evidence based upon memory without further substantiation is **not** acceptable.

16. What do you mean by depreciation "allowed or allowable"?

The IRC allows a taxpayer to depreciate any property having a limited useful life if the property is used in a trade or business. Renting a property for income is a trade or business. For purposes of calculating gain or loss on the disposition of a trade or business asset, the basis of property is reduced by the depreciation allowed or allowable, whichever is greater. Depreciation allowed is depreciation actually deducted and for which a tax benefit was received, unless the claimed amount was reduced by the Department. Depreciation allowable is depreciation that could have been taken on your tax return. The basis of the property is still reduced by the full amount of depreciation that could have been taken, even if you did not claim depreciation that you were entitled to deduct. For further information on depreciation, please see IRS Publication 946 ("How to Depreciate Property").

17. What is a "capital improvement"?

Capital improvements add value to the property and have a useful life in excess of one year, prolong the property's life, or adapts it to new uses. This should not be confused with a non-eligible repair, which just returns something to its original condition. Capital improvements can include everything from a new bathroom or deck to a new water heater or furnace. However, the improvements must still be evident when you sell. For further information, please refer to IRS Publication 551 ("Basis of Assets").

Example 1:

In Year 1, Transferor/seller purchases a home for his residence. He replaces the wall-to-wall carpet with new carpeting. In Year 10, Transferor/seller sells the residence. The carpeting is still installed. The cost of the carpet may be added to the cost of the residence in determining the amount of any gain.

Example 2:

Same facts as Example 1, except that the Transferor/seller replaced the carpet in Year 5 with hardwood floors. The cost of the carpeting is not a capital improvement and does not increase the basis since it is no longer evident in the home. However, the cost of the hardwood floors may be added to the basis.

Example 3:

Same facts as Example 2, except that the Transferor/seller in Year 6 had to repair a portion of the hardwood floor due to a water leak. The cost of the repairing the hardwood floor does not increase the basis as it was done to maintain the home's good condition and does not add value or prolong its life

18. I am selling my home along with the furnishings. Does the cost of the furnishings increase the basis of the home?

If the furnishings are removable without incurring substantial damage to the unit, the cost of the furnishings does not increase the basis. For example, the cost of a stand alone refrigerator or drapes cannot be added to the basis of the home, even though the refrigerator and drapes are included in the sales contract. Generally speaking, a sale of real property and its furnishings are really two sales: a sale of the real property and a sale of the furnishings. However, unless the Transferor/seller can document the value of the furnishings and unless the sales agreement apportions the sales price between the real property and the furnishings, the amount of the sales price assigned to the furnishings is zero. Unless the furnishings were used in a trade or business, any loss resulting from the sale of the furnishings is a personal loss and is therefore non-deductible. See also IRS Publication 523 ("Selling Your Home").

Example 1:

In year 1, Transferor/seller buys a condominium for her personal summer residence. She purchases new appliances, including a washer/dryer combination, range, refrigerator, and air conditioner. These may be removed without damaging the unit. In Year 5, Transferor/seller sells the condominium, including the aforementioned items. The cost of the appliances does not increase the basis in the condominium, and the amount of the sales/purchase price assigned to the appliances is zero. Transferor/seller may have a loss with respect to the appliances, but the loss is personal and does not reduce the amount of gain on the sale of the condominium.

Example 2:

In year 1, Transferor/seller buys a condominium for her personal summer residence. She also purchases a Picasso painting for $500,000 for display in the residence. The painting may be removed without damaging the unit. In Year 5, Transferor/seller sells the condominium, including the Picasso.

The purchase/sales agreement establishes a value of $1 million for the Picasso, which is corroborated by expert appraisals. The cost of the Picasso does not increase the basis in the condominium. However, the portion of the purchase/sales price assigned to the Picasso is not included in determining the amount that is required to be withheld. There are two purchase/sales agreements that are operative simultaneously: one for the purchase of the real property and one for the purchase of the Picasso. The purchase/sale of the real property is subject to the provisions of HARPTA, but the purchase/sale of the Picasso is not. However, the Transferor/seller is obligated to file a Hawaii tax return for the year of disposition reporting the gain or loss from all activities, including from the sale of the Picasso, as well as any other Hawaii sourced income.

19. Has the State adopted IRC Section 121, as modified by the Taxpayer Relief Act of 1997?

The State has adopted IRC 121 as modified, which allows a Transferor/seller who has used the property being sold as his/her primary residence to exclude up to $250,000 ($500,000 if married and filing a joint return) of the gain on the sale. To be eligible, the taxpayer must both own and use the home as a principal residence for two of the five years before the sale. The ownership and use periods need not be concurrent. The two years may consist of 24 full months or 730 days. Short absences, such as for a summer vacation, count as periods of use, but longer breaks, such as a one-year sabbatical, do not. The taxpayer also must not have excluded gain on another home sold during the two years before the current sale.

The $500,000 exclusion applies only if all of the following occur: (a) they are married and file a joint return for the year of sale, (b either (or both) the taxpayer or his/her spouse meet the ownership test, (c) both the taxpayer and his/her spouse meet the use test, and (d) neither the taxpayer nor his/her spouse excluded gain from the sale of a principal residence during the prior two years.

A reduced exclusion is available, even if the taxpayer lived in the home less than 24 months, if the sale of the home occurred because the location of the taxpayer's job changed, because of health concerns, or for certain other unforeseen circumstance. Please see IRS Publication 523 ("Selling Your Home") for further information.

A Transferor/seller seeking to eliminate the amount of withholding required because of the gain exclusion should submit Form N-288B along with required documentation. As noted above, the issuance of a withholding certificate does not relieve the Transferor/seller of the duty of filing a Hawaii income tax return for the year of transfer.

Example 1:

Husband and Wife purchase a home in 1947. In 2008, Husband and Wife decide to retire in Arizona and permanently move there. Because of conditions in the real estate market, they decided not to sell their home immediately and left it vacant in care of relatives. In Year 2010, they sell their home when market conditions had improved. The sales price was $600,000 and the basis in the home at the time of sale was $100,000. They are married at the time of sale and have not previously had gain excluded from the sale of a principal residence. Since Husband and Wife are entitled to the Section 121 exclusion, the amount required to be withheld under HARPTA may be eliminated if they provide the Transferee/buyer an approved Form N-288B. Husband and Wife must still file a Hawaii income tax return for the year of sale.

20. What happens if there are insufficient funds from the sale to pay all outstanding mortgages and the costs of sale?

HARPTA withholding may be reduced or eliminated if there will be insufficient proceeds from the sale to pay the HARPTA withholding in full. In such situations, Form N-288B along with a good faith estimate of the closing statement should be submitted to the Department at least ten days prior to closing. The issuance of a withholding certificate does not relieve the Transferor/seller of the duty of filing a Hawaii income tax return for the year of transfer

21. My house is in foreclosure, and a commissioner has been appointed by the court to sell it. Can the commissioner submit a Form N-288B showing that the proceeds of sale are insufficient to pay the costs of sale and all liens and other encumbrances?

A commissioner or other duly appointed fiduciary, acting within the scope of his/her authority, has the power to submit a Form N-288B showing that the proceeds of sale are insufficient to pay the costs of sale and all liens and other encumbrances, provided that he/she has personal knowledge of the situation. A commissioner in a foreclosure or similar sale is an agent for the Transferor/seller. However, the commissioner's authority is limited to selling the property and the acts associated with such sale. A commissioner does **not** have the authority to file Form N-288C seeking a tentative refund, since the commissioner's authority is limited in scope. It is also important to remember that a commissioner or similar agent appointed to act on behalf of the Transferor/seller is **not** the owner of the real property being sold and title to the property does not transfer from the Transferor/seller to the commissioner or other similar agent when the commissioner or other similar agent is appointed. The Transferor/seller remains the owner of the property until it is sold, and is responsible for filing tax returns reporting the sale (along with any other Hawaii sourced income), and to pay any tax due.

22. At the foreclosure sale, the lender was the high bidder and the sale was confirmed by the court. The lender is now selling the property to me for more than the amount paid at auction, but less than the amount that was owed by the defaulting borrower. Must I withhold 5% of the purchase price?

It is important to remember that there are two separate sales occurring in these situations. The first sale occurs when the lender purchases the property from the defaulting borrower, and the second is when the lender sells the property. Each sale must be analyzed independently to determine if HARPTA withholding is required. It is likely that no withholding would be required in the sale from the defaulting borrower to the lender, but withholding may be required upon the sale from the lender to the new purchaser, unless some exception applies, such as the lender/seller being registered to do business in Hawaii. Unless the lender/seller provides a Form N-288B or Form N-289, the Transferee/buyer must withhold.

23. The escrow company made a miscalculation and erroneously paid to the Department a withholding amount. May escrow apply for a refund of the overpayment?

As noted in Question No. 5 above, payment made to the Department under HARPTA is an estimated tax payment and credited to the account of the taxpayer-Transferor/seller. Once payment is made to the Department, only the taxpayer-Transferor/seller is entitled to seek a refund of the withheld amount, even if the amount paid to the Department was due to an error made by the escrow company. The taxpayer-Transferor/seller may be entitled to a tentative refund (See Question No. 7 above), but it is incumbent upon the taxpayer-Transferor/seller to seek such refund. The Department is unable to process any refund request submitted by any other party, including the escrow company or mortgage company.

24. The amount of the secured indebtedness exceeds the sales price. How can I still owe taxes?

Many taxpayers mistakenly use "gain" and "equity" interchangeably. However, these concepts are different. Gain is the excess of net sales proceeds over the adjusted basis of the property being transferred, and is the base upon which capital gains tax is calculated. Equity is the amount of value remaining after paying off all mortgages and any other liens encumbering the property. You could have a taxable gain even if you have no equity in the property. This commonly occurs when properties are refinanced or equity lines of credit are taken out, but no capital improvements are made to the property. Under certain conditions, a cancellation of debt may also result in taxable income.

Example 1:

Taxpayer purchases a condominium for investment and rents it out. The purchase price was $100,000. Three years after purchasing the property, the value of the condominium has increased to $400,000. The taxpayer refinances the property by encumbering the property with a new first mortgage of $300,000. Taxpayer uses the proceeds of the new loan to pay off the original first mortgage and the balance of the monies for personal and other expenses unrelated to the condominium. Five years later, the taxpayer sells the condominium for $300,000. At that time, the mortgage balance is $295,000, costs associated with the sale is $15,000, and depreciation allowed or allowable is $18,182. The taxpayer made no other improvements to the condominium in the period of ownership. Taxpayer has no equity in the property, but does have a capital gain as follows:

Sales price		$300,000
-Cost of sale		(15,000)
Adjusted sales price		$285,000
-Basis:		
Original Cost	$100,000	
-Depreciation	(18,182)	(81,818)
Gain on Sale		**$203,182**

The taxpayer-Transferor/seller is required to file a Hawaii income tax return for the year of transfer and to pay the tax due, even though he/she did not receive any proceeds of the sale. HARPTA still applies, but exempts the Transferee/buyer from any withholding requirements if the Transferor/seller provides a withholding certificate from the Department. The Transferee/buyer must comply with the withholding requirement if the Transferor/seller does not provide a certificate.

25. What is Cancellation of Debt income?

If you borrow money and the lender later cancels or forgives the debt, you may have to include the cancelled amount in income for tax purposes, depending on the circumstances. When you borrowed the money you were not required to include the loan proceeds in income because you had an obligation to repay the lender. When that obligation is subsequently forgiven, the amount you received as loan proceeds is reportable as income because you no longer have an obligation to repay the lender. The lender is usually required to report the amount of the canceled debt to you and the IRS on a Form1099-C, Cancellation of Debt. For further information, please refer to IRS Publication 4681 ("Canceled Debts, Foreclosures, Repossessions, and Abandonments").

Example 1:

Taxpayer purchases for $300,000 a condominium as his/her personal residence, paying $15,000 down and the balance through a new first mortgage loan of $285,000. The loan is recourse, meaning that the taxpayer is personally liable for the mortgage. When the remaining balance of the loan is $280,000, taxpayer loses his/her job and cannot pay the mortgage, thereby defaulting. The lender bank accepts his/her voluntary conveyance of the unit in exchange for canceling the loan. Similar units are selling at $230,000 at the time the conveyance to the bank is executed.

The transaction is a disposition and is treated as a sale. Taxpayer has a loss of $70,000 (adjusted basis of $300,000 minus the fair market value of $230,000), which is nondeductible because it is a personal loss. The taxpayer may also have cancellation of debt income of $50,000 (the outstanding amount of the debt ($280,000) less the fair market value of the property surrendered ($230,000)) when the loan is forgiven.

26. Is Cancellation of Debt income always taxable?

Certain situations may reduce or eliminate the taxable amount on the cancellation of debt income. The most common situations when cancellation of debt income is not taxable are:

Bankruptcy: Debts discharged through bankruptcy are not considered taxable income;

Insolvency: If you are insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable to you. You are insolvent when your total debts are more than the fair market value of your total assets. Insolvency can be fairly complex to determine and the assistance of a tax professional is recommended if you believe you qualify for this exception.

In addition, the Mortgage Forgiveness Debt Relief Act of 2007 (Public Law 110-142, HR 3648), provides relief from cancellation of debt income for certain homeowner-occupants until December 31, 2012. It is limited to debts of $2 million or less and does not apply to rental properties or other non-primary residences. It also applies only to forgiven or cancelled debt used to buy, build or substantially improve the principal residence, or to refinance debt incurred for those purposes. Refinanced debt qualifies for this exclusion, but only up to the extent that the principal balance of the old mortgage, immediately before the refinancing, would have qualified. It is important to note that cancellation of debt income is treated as ordinary income and not as capital gains.

27. What if I have a non-recourse loan?

A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue you personally in case of default. Transferors that are not personally liable for a debt realize an amount that includes the full amount of the canceled debt, even if the value of the property that is security for the debt is less, and as such, there is generally no cancellation of debt income.

Example 1:

Taxpayer purchases for $300,000 a condominium as his/her personal residence, paying $15,000 down and the balance through a new first mortgage loan of $285,000. The loan is non-recourse, meaning that the taxpayer is not personally liable for the mortgage. When the remaining balance of the loan is $280,000, taxpayer loses his/her job and cannot pay the mortgage, thereby defaulting. The lender bank accepts his/her voluntary conveyance of the unit in exchange for canceling the loan. Similar units are selling at $230,000 at the time the conveyance to the bank is executed.

The transaction is a disposition and is treated as a sale. The amount received is deemed to be the amount of the cancelled debt. Thus, the taxpayer has a loss of $20,000 (adjusted basis of $300,000 minus the amount received through cancellation of debt of $280,000), which is nondeductible because it is a personal loss. There is no cancellation of debt income even though the fair market value of the property surrendered is less than the loan forgiven because the loan was non-recourse.

28. Are there any exceptions to the withholding requirements of HARPTA?

Yes. No withholding is required if the Transferor/seller furnishes to the Transferee/buyer an affidavit stating the Transferor/seller's taxpayer identification number and

a. The Transferor/seller is a Hawaii resident person; OR
b. That by reason of a nonrecognition provision of the Internal Revenue Code (which is also operative for the State), or if the provisions of any United States treaty prohibits the imposition of State taxes upon the disposition, the Transferor/seller is not required to recognize any gain or loss with respect to the transfer. The Transferor/seller must provide a summary of the law and facts which support the claim of nonrecognition.

No withholding is also required if the amount realized for the property does not exceed $300,000 and one or more individual transferors provide an affidavit to the Transferee/buyer stating the Transferor/seller's taxpayer identification number and also stating that for the year preceding the date of the transfer, the property has been used by the Transferor/seller as a principal residence. This exception applies only to individuals and not to artificial entities. NOTE: This differs from FIRPTA, which exempts a transaction if the Transferee/buyer purchases real estate which **will** be used as his/her personal residence and the purchase price is not more than $300,000.

To claim an exemption from the withholding requirements of HARPTA under any of these exceptions, the Transferor/seller must provide to the Transferee/buyer (or escrow) Form N-289. Form N-289 may be used only if the Transferor/seller is a Hawaii resident person or if none of the gain is taxable because of a United States treaty or because of a nonrecognition provision of the IRC.

29. What are some of the nonrecognition of gain or loss provisions that are operative for the State?

The most commonly encountered provision in real estate is the section 1031 exchange, which is governed by section 1031 of the IRC. A section 1031 exchange allows the Transferor/seller to reduce or to defer capital gains taxes on the sale of investment real estate when it is exchanged for other investment real estate within a prescribed period of time. For purposes of the HARPTA exemption from withholding, the Transferor/seller does not need to replace the property with another property in Hawaii. Form N-289 is only applicable if **none** of the gain is taxable. If you receive cash, property that is not like-kind, or are relieved of debt, some taxable gain may be recognized in the year of the exchange. Likewise, there can be both deferred and recognized gain in the same transaction when a taxpayer exchanges for like-kind property of lesser value. If any amount of gain is recognized in a 1031 exchange, Form N-289 cannot be used to eliminate the withholding requirements of HARPTA.

Example 1:

Investor purchases an apartment building for $250,000. Five years later, in a qualified 1031 transaction, Investor exchanges the apartment building for another apartment building worth $400,000 and stock worth $50,000. Although a portion of the transaction qualifies for deferral of gain, the receipt of the stock causes an immediate recognition of gain up to the value of the stock, and as such, Form N-289 cannot be used to eliminate the withholding requirement of HARPTA. Transferee/buyer is required to withhold the full 5% of the amount realized, which includes the value of the stock received.

Some other common nonrecognition events are transfers by gift, transfers incident to a divorce, and transfers received by bequest. While no gain or loss is reported at the time of these transfers, it is still necessary to provide the Transferee/buyer Form N-289

For additional information regarding this Tax Facts, please see Tax Information Release 2002-2 or call (808) 587-1577. Forms and publications referenced in this Tax Facts are available at our website at www.hawaii.gov or at any of our district tax offices listed below. Forms and publications can be mailed to you by calling 587-4242 or toll-free at 1-800-222-3229.

STATE DISTRICT TAX OFFICE ADDRESSES & TELEPHONE NUMBERS

Website (Forms & Information)
www.hawaii.gov/tax

Forms & Information
808-587-4242
Toll-Free: 1-800-222-3229

Telephone Devices for the Deaf (TDD)
Tax Service & Processing
808-587-1418
Toll-Free: 1-800-887-8974

Oahu District Tax Office
830 Punchbowl Street
P. O. Box 259
Honolulu, HI 96809-0259

Telephone No.: 808-587-4242
Toll-Free: 1-800-222-3229
Fax No.: 808-587-1488

Maui District Tax Office
54 South High Street #208
Wailuku, HI 96793-2198

Telephone No.: 808-984-8500
Fax No.: 808-984-8522

Hawaii District Tax Office
75 Aupuni Street #101
Hilo, HI 96720-4245

Telephone No.: 808-974-6321
Fax No.: 808-974-6300

Kauai District Tax Office
3060 Eiwa Street #105
Lihue, HI 96766-1889

Telephone No.: 808-274-3456
Fax No.: 808-274-3461

Tax Facts is a publication of the Department of Taxation on tax subjects of current interest and is not intended to be a complete statement of the law. Subsequent developments in the law (legislation, rules, cases, etc.) should be consulted.