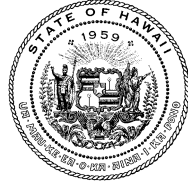


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January 7, 2014

TAX INFORMATION RELEASE NO. 2002-2 (REVISED 1/2014)

RE: Withholding of State Income Taxes on the Disposition of Hawaii Real Property

Section 235-68, Hawaii Revised Statutes (HRS), provides for the withholding of tax on the disposition of Hawaii real property by nonresident persons and is commonly referred to as "HARPTA". Section 235-68, HRS, requires every transferee/buyer¹ to withhold and pay to the Department of Taxation (Department) 5 percent of the amount realized on the disposition of Hawaii real property, unless the disposition is exempt from withholding.

This withholding requirement is similar to the federal withholding tax on the disposition of United States real property. See section 1445, Internal Revenue Code (IRC) of 1986, as amended, relating to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). To the extent that they are applicable and practicable, the Department follows the provisions of FIRPTA and the regulations applicable to IRC section 1445.

This Tax Information Release (TIR) supersedes TIR No. 90-14 and TIR No. 91-7.

I. Disposition of Hawaii Real Property² by a Nonresident Person is Subject to Withholding

A. Definition of Nonresident Person

The term "nonresident person" means every person other than a resident person. Section 235-68(a), HRS.

¹ "Transferee" means any person, the State and the counties and their respective subdivisions, agencies, authorities, and boards, acquiring real property which is located in Hawaii. Section 235-68(a), HRS.

² "Property" or "real property" means real property as the term is defined in section 231-1, HRS; specifically, 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.

B. Definition of Resident Person

"Resident person" means any:

- (1) Individual included in the definition of resident in section 235-1;
- (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; provided that if a single member limited liability company has not elected to be taxed as a corporation, the single member limited liability company shall be disregarded for purposes of section 235-68 and section 235-68 shall be applied as if the sole member is the transferor/seller;
- (6) Limited liability partnership formed under chapter 425;
- (7) Foreign limited liability partnership qualified to transact business under chapter 425;
- (8) Trust included in the definition of resident trust in section 235-1; or
- (9) Estate included in the definition of resident estate in section 235-1.

The residency status of a person is determined at the time of the disposition of the property; i.e., if the person is not a Hawaii resident when the sale closes, the transferee/buyer must withhold 5 percent of the amount realized unless the sale is exempt from withholding.

C. Residency Status of a Partnership or a Limited Liability Company (LLC)

In general, the residency status of the partnership or a LLC, not its partners or members, determines whether withholding is required on the disposition of Hawaii real property. Thus, a partnership formed under chapter 425, HRS, or a LLC formed under chapter 428, HRS, is a resident person, and withholding is not required. Withholding also is not required if a foreign³ partnership or LLC is registered to transact business in Hawaii. See section I.B. Conversely, withholding is required if a foreign partnership or LLC is not registered to transact business in Hawaii.

Irrespective of the withholding of taxes, the partnership or LLC must later file an informational Hawaii income tax return at the end of its tax year. Regardless of whether withholding is required, both resident and nonresident partners or members must file a Hawaii income tax return to report the disposition of Hawaii real property.

³ A foreign partnership or LLC means an entity that was formed under the laws of any jurisdiction except Hawaii.

However, where a single-member LLC has not elected to be taxed as a corporation, the withholding provisions are to be applied without regards to the existence of the LLC, and instead the residency of the single-member would be considered to determine whether withholding is required on the disposition of Hawaii real property. Regardless of whether withholding is required, both resident and nonresident single-members must file a Hawaii income tax return to report the disposition of Hawaii real property.

D. Joint Transferors/Sellers⁴

If a nonresident person and a resident person jointly dispose of Hawaii real property, the transferee/buyer is required to withhold the tax on the amount realized by the nonresident person.

The amount subject to withholding may be determined by allocating the amount realized based upon the capital contributions made to purchase the property; if an allocation cannot be determined, 50 percent of the amount realized is presumed to be allocated to the nonresident person.

Unless the circumstances require otherwise, spouses are treated as each receiving 50 percent of the amount realized.

In order that the withheld amount be properly reported by the transferee/buyer and properly credited by the Department to the transferor's/seller's account, each transferor/seller should notify the transferee/buyer about the allocation of the amount realized prior to the date of transfer. This notification may be delayed for good cause, but should be made no later than the tenth day after the date of transfer.

II. Withholding Not Required

Withholding of tax is not required for a disposition of Hawaii real property if the transferor/seller furnishes to the transferee/buyer a certification (Form N-289) that establishes:

- The transferor/seller is a resident person;
- By reason of a nonrecognition provision of the IRC as operative under chapter 235, HRS, or the provisions of any United States treaty, the transferor/seller is not required to recognize any gain or loss with respect to the transfer; or
- For the year preceding the date of the transfer, the property has been used by the transferor/seller as a principal residence and the amount realized for the property does not exceed \$300,000.

Although the withholding of tax may not be required, the transferor/seller is required to

⁴ "Transferor" means any person disposing real property that is located in Hawaii. Section 235-68(a), HRS.

file a Hawaii income tax return to report the sale or other disposition.

A. Withholding Not Required if an IRC Nonrecognition Provision is Applicable

Examples of IRC nonrecognition provisions include the disposition of real property under sections: 102 (with respect to gifts and inheritances), 332 (with respect to complete liquidations of subsidiaries), 337 (with respect to nonrecognition for property distributed to parent in complete liquidation of subsidiary), 351 (with respect to transfer to corporation controlled by transferor), 721 (with respect to nonrecognition of gain or loss on contribution), 1031 (with respect to exchange of property held for productive use or investment), and 1041 (with respect to transfers of property between spouses or incident to divorce). If withholding is not required, the transferor/seller must furnish to the transferee/buyer Form N-289.

B. Withholding Not Required if the Property is Used as a Principal Residence and the Amount Realized Does Not Exceed \$300,000

Withholding of tax is not required if, for the year preceding the date of the disposition, the real property has been used by the transferor/seller as a principal residence and the amount realized for the property does not exceed \$300,000. If withholding is not required, the transferor/seller must furnish to the transferee/buyer Form N-289.

III. Withholding on an Agreement of Sale or a Purchase Money Mortgage

A. Hawaii Adopts IRC Installment Method Provision

Hawaii adopts IRC section 453 (with respect to the installment method), which provides that the gain from a disposition of property where the transferor/seller is to receive at least one payment after the tax year in which the disposition took place must be reported under the installment method, unless the transferor/seller elects otherwise.

B. Withholding on an Agreement of Sale or a Purchase Money Mortgage

Tax on payments on an agreement of sale or a purchase money mortgage the transferee/buyer makes to the transferor/seller shall be withheld as follows:

- (1) In situations where the transferor/seller reports the gain under the installment method, the transferee/buyer must withhold the annual amount of the tax from the first payment of each year for the term of the agreement of sale or the purchase money mortgage. The withholding of tax applies only to the principal portion of the total payments for the year and does not apply to any interest amounts. The amount withheld must be paid over to the Department by the twentieth day after the first payment of the year is made.

- (2) In situations where the transferor/seller elects out of the installment method under IRC section 453, the transferee/buyer must withhold on the entire amount realized (excluding interest amounts). The amount withheld must be paid over to the Department by the twentieth day after the date of transfer.

The transferor/seller must provide written notification to the transferee/buyer prior to the date of transfer if the transferor/seller will elect out of the installment method and report the gain in full in the year of sale. If the transferee/buyer does not receive this written notification, the transferee/buyer shall assume that the transferor/seller will report the gain under the installment method.

Example 1: Hawaii real property is sold on Agreement of Sale or Purchase Money Mortgage by a nonresident person for \$1,100,000:

• Cash down payment	\$200,000
• Assumption of existing mortgage	400,000
• 5-year purchase money mortgage or agreement of sale	<u>500,000</u>
Total amount realized	\$1,100,000

- (1) If the transferor/seller reports the gain under the installment method, the assumption of an existing mortgage is treated as the receipt of cash for withholding purposes. The amount that must be withheld at the time of closing, therefore, is 5 percent of the sum of the amount of the cash down payment and the assumption of the existing mortgage ($5\% \times [\$200,000 + \$400,000] = \$30,000$).

With respect to the purchase money mortgage, if principal payments of \$100,000 are paid each year, then \$5,000 ($5\% \times \$100,000$) must be withheld by the transferee/buyer at the beginning of each year.

If, instead, the \$500,000 is under a 5 year agreement of sale, \$25,000 ($5\% \times \$500,000$) must be withheld by the transferee/buyer when the agreement of sale is completed.

- (2) If the transferor/seller (nonresident person) elects out of the installment method, the amount that must be withheld at the time of closing is \$55,000 ($5\% \times \$1,100,000$).

IV. Waiver or Adjustment of Withholding

The transferor/seller may apply for a withholding certificate to waive or adjust withholding on a disposition of Hawaii real property if:

- The transferor/seller will not realize any gain with respect to the transfer, or
- There will be insufficient proceeds to pay the withholding after payment of all costs, including selling expenses and the amount of any mortgage or lien secured by the property.

Although the withholding of tax may be waived, the transferor/seller is required to file a Hawaii income tax return to report the sale or other disposition.

A. Transferor/Seller Will Not Realize a Gain or Incurs a Loss

The amount realized is subject to withholding even if the transferor/seller will not realize a gain or incur a loss on the disposition of Hawaii real property. The transferor/seller, however, may request from the Department, a waiver from withholding by submitting Form N-288B (Application for Withholding Certificate for Dispositions by Nonresident Persons of Hawaii Real Property Interest) to the Department in the taxation district where the property is located no later than ten business days prior to the date of transfer.⁵ The transferor/seller must include the calculation, justification, and all supporting documents⁶ that establish that the transferor/seller will not realize a gain or incur a loss. Form N-288B must have the original (not faxed or photocopied) signature of the transferor/seller or the individual representing the transferor/seller by a power of attorney (not a general authorization granted by an escrow company) on Hawaii Form N-848.

If the Department determines that the transferor/seller will not realize a gain or incur a loss, the Department will approve the waiver and return Form N-288B to the transferor/seller.

The transferor/seller shall transmit the form to the transferee/buyer, who will no longer be required to withhold any tax. The transferee/buyer shall attach the Form N-288B to Forms N-288 (Hawaii Withholding Tax Return for Dispositions by Nonresident Persons of Hawaii Real Property Interests) and N-288A (Statement of Withholding on Dispositions by Nonresident Persons of Hawaii Real Property Interests), which must still be filed with the Department by the transferee/buyer.

⁵ On Oahu, the form should be submitted to the Office Audit branch.

⁶ Supporting documents include copies of documents establishing the transferor's/seller's basis in the property, escrow company closing statement, county real property records showing the purchase price, conveyance tax return showing taxes paid, title insurance policy, or executed sales or purchase agreements.

Hawaii adopts IRC section 121, which allows an exclusion of \$250,000 (\$500,000, married filing jointly) of gain derived from the sale or exchange of a principal residence.

Example 2: Mr. and Mrs. Aloha are Hawaii residents when they list their principal residence for sale before they move to California. Mr. and Mrs. Aloha are California residents when their residence is sold six months later for \$450,000. The sale of the residence is subject to withholding, but they may submit Form N-288B to apply for a waiver from withholding because IRC section 121 excludes the gain from the sale of a principal residence.

Withholding of tax is not required for military personnel stationed in Hawaii who sell a principal residence and can exclude the gain under IRC section 121. The military personnel must submit Form N-288B to the Department to apply for a waiver from the withholding.

B. Transferor/Seller Realizes a Gain, but There are Insufficient Funds to Pay the Tax

If the transferor/seller realizes a gain on the disposition of real property, but there are insufficient funds to fulfill the withholding requirement, the transferor/seller may apply to the Department in the taxation district where the property is located for an adjustment to the amount to be withheld. The transferor/seller must submit Form N-288B to the Department no later than ten business days prior to the date of transfer of the property. The transferor/seller must include an explanation for the insufficiency of funds and supporting documents.

The Department will adjust the withholding amount only when the circumstances clearly indicate that there are insufficient funds to fulfill the required amount to be withheld or the withholding is extremely burdensome to the parties and that without an adjustment the transaction cannot occur. Taxpayers are cautioned against applying for adjustments or submitting information that frivolously overstates the necessity for an adjustment in the withholding amount.

If the Department determines an adjustment to the withholding amount is correct, an adjusted withholding amount will be approved. The Department will return the form to the transferor/seller, who shall transmit the form to the transferee/buyer. The transferee/buyer then shall withhold the adjusted amount (if not completely waived) and submit the payment of tax, Form N-288B, Form N-288, and Form N-288A to the Department.

C. Similarities and Differences Between the Hawaii Withholding Law and FIRPTA

The Hawaii withholding law is similar to the FIRPTA withholding tax on the disposition of United States real property, which requires the transferee/buyer to withhold 10 percent of the amount realized by a foreign person. Both the Hawaii withholding law and FIRPTA do not allow travel expenses relating to the improvement or disposition of the property to be included in the adjusted basis of the property.

There are some differences, however, including the following:

- (1) The Hawaii withholding law does not allow an adjustment to the amount of State income tax withholding based on FIRPTA's "maximum tax liability" which adjusts the FIRPTA withholding amount if the transferor's/seller's maximum tax liability is less than the tax required to be withheld;⁷
- (2) The Hawaii withholding law does not include the value of tangible personal property (e.g., furniture and fixtures, equipment) in the adjusted basis of the property while FIRTPA may allow "associated personal property" to be included in the adjusted basis;⁸
- (3) The Hawaii withholding law does not recognize a tax rate reduction authorized under a tax treaty; and
- (4) The Hawaii withholding law requires the tax to be withheld and paid to the Department even though a determination for a waiver or reduction of the withholding amount is pending while FIRPTA does not require the payment until a determination is made by the IRS.

D. Persons Engaging in Multiple Transactions or Withholding Requirements are Not Practicable

The Department may enter into written agreements with persons who engage in more than one real property transaction a year or other persons to whom meeting the withholding requirements are not practicable. The written agreements may waive the withholding requirement or allow the use of a withholding method other than specified in section 235-68, HRS.

V. Payment of Tax Withheld to the Department

A. Transferee/Buyer is Required to Withhold and Pay 5 Percent of the Amount Realized

The transferee/buyer is required to withhold and pay 5 percent of the amount realized⁹ to the Department, unless the transferor/seller furnishes a Form N-289 (Certification for Exemption from the Withholding of Tax on the Disposition of Hawaii Real Property) to the transferee/buyer.

⁷ IRS Revenue Procedure 2000-35, section 4.06.

⁸ Federal Form 8288-B, Specific Instructions, line 6c, relating to "associated personal property" and IRS Regulations section 1.897-1.

⁹ "Amount realized" means the sum of the cash paid or to be paid (not including interest or original issue discount), the fair market value of other property transferred or to be transferred, and the amount of any liability assumed by the transferee/buyer or to which the Hawaii real property interest is subject immediately before and after the transfer. Generally, the amount realized is the sales or contract price.

Every transferee/buyer who is required to withhold the tax must report and pay the amount withheld to the Department by the twentieth day after the date of transfer, unless exempt from withholding.¹⁰ The Department will accept as timely filed, withholding tax forms which are deposited in the U.S. mail and postmarked within the twenty-day time period following the date of transfer of the property.

B. Transferee/Buyer Uses Forms N-288 and N-288-A to Pay the Tax

A transferee/buyer uses Form N-288 and Form N-288A to report and pay the tax. There must be a Form N-288A for each transferor/seller (spouses filing a Hawaii income tax return jointly may use one Form N-288A).¹¹

If the transferee/buyer receives a Form N-288B from the transferor/seller (this form is used to apply for a waiver or adjustment of amount withheld), this form should be attached to Forms N-288A and N-288.

If two or more persons are joint transferees/buyers, the full responsibility to withhold the tax falls on each person.

C. Transferee/Buyer Must Withhold Tax for a Disposition That is Partially Exempt Under an IRC Nonrecognition Provision

A disposition of real property, such as an exchange, defers income tax consequences because the gain or loss is not recognized under the IRC at the time of disposition. Some transactions, however, may result in partial recognition of gain (boot) by the transferor/seller. A disposition which results in partial recognition of gain by the transferor/seller is subject to withholding on the gain recognized.

D. Transferee/Buyer Receives a False Form N-289

If the transferee/buyer receives notice after the date of transfer that the Form N-289 (Certification for Exemption from the Withholding of Tax on the Disposition of Hawaii Real Property) is false, the transferee/buyer may rely on the certificate provided and is not liable for the withholding of the tax on the consideration paid to the transferor/seller before receiving the notice.

¹⁰ "Date of transfer" means the first date on which consideration is paid or a liability is assumed by the transferee/buyer. Payment of consideration does not include the payment before passage of legal or equitable title of earnest money (other than pursuant to an initial purchase contract), a good-faith deposit, or any similar amount primarily intended to bind the parties to the contract and subject to forfeiture. A payment that is not forfeitable may also be considered earnest money, a good-faith deposit, or similar sum.

¹¹ Forms N-288A and N-288 are not required to be submitted to the Department if all transferors/sellers have provided a certification of exemption (Form N-289).

If, however, the full amount of the consideration has not yet been paid (e.g. installment sale), the transferee/buyer must withhold 5 percent of the amount of each periodic payment received. This amount must be paid to the Department by the twentieth day following the date the periodic payment is received.

If the transferee/buyer has actual knowledge that the Form N-289 received is false, the transferee/buyer is required to withhold and pay the tax. If the transferee/buyer is required to, but fails to withhold and pay the tax, the transferee/buyer is liable for the tax.

E. Penalties for Not Withholding or Paying the Tax¹²

A transferee/buyer who fails to file Form N-288 on a timely basis may be subject to a penalty of 5 percent of the amount of the tax (unless it is shown that the failure is due to reasonable cause and not due to neglect), if the failure is not more than a month, with an additional 5 percent for each additional month or fraction of a month, not exceeding 25 percent.¹³

A transferee/buyer who fails to pay the tax that is due to negligence or intentional disregard of the rules may be subject to a penalty of up to 25 percent of the amount of the tax (up to 50 percent if due to fraud as determined by the director of taxation).¹⁴

Interest on underpayment of tax or nonpayment of tax may be added at the rate of two-thirds of one percent a month or fraction of a month from the first calendar day after the date prescribed for payment of the tax.¹⁵

A transferee/buyer who wilfully fails to make a return, make a report, keep any records or supply any information regarding the withholding taxes may be convicted of a misdemeanor and be subject to one or any combination of a fine of not more than \$25,000, imprisonment of not more than one year or probation.¹⁶

¹² Section 235-68(e), HRS, provided for a fine of not more than \$1,000 or imprisonment of not more than one year, or both, to any transferor/seller who wilfully supplied false or fraudulent information on an affidavit or withholding certificate. Section 235-68(e), HRS, was repealed by Act 92, SLH 1995. Under current law, the penalties in sections 231-34, 231-35, 231-36, and 231-39, HRS, apply to taxes imposed under Title 14, HRS, including the withholding of taxes on the disposition of Hawaii real property by nonresidents.

¹³ Section 231-39(b)(1), HRS.

¹⁴ Section 231-39(b)(2), HRS.

¹⁵ Section 231-39(b)(4), HRS.

¹⁶ Section 231-35, HRS.

A transferor/seller or transferee/buyer who wilfully attempts in any manner to evade or defeat the withholding of taxes or its payment may be convicted of a class C felony and be subject to one or any combination of a fine of not more than \$100,000 (not more than \$500,000 for corporations), imprisonment of not more than five years or probation.¹⁷

A transferor/seller or transferee/buyer who wilfully makes and subscribes any return, statement or other document required to be made regarding the withholding of taxes which contains or is verified by a written declaration that it is true and correct as to every material matter (or wilfully aids, assists in, procures, counsels or advises the preparation or presentation of any tax return, affidavit, claim, or other document required to be made which is fraudulent or false as to any material matter) may be convicted of a class C felony and be subject to one or any combination of a fine of not more than \$100,000 (not more than \$500,000 for corporations), imprisonment of not more than three years or probation.¹⁸

VI. Refund of Amounts Withheld That Exceeds the Transferor's/Seller's Tax Liability

There are two ways that a transferor/seller may apply for a refund of amounts withheld that exceed the transferor's/seller's tax liability. First, a transferor/seller may apply for a refund when the transferor/seller files a Hawaii income tax return for the year.

Second, a transferor/seller may file Form N-288C (Application for Tentative Refund of Withholding on Dispositions by Nonresident Persons of Hawaii Real Property Interests) to adjust the amount of tax withheld and receive an early refund of the amount that exceeds the transferor's/seller's tax liability for the transaction. The transferor/seller must present sufficient information on Form N-288C regarding the basis, sales price, and gain on the property as determined by Hawaii income tax law. After reviewing Form N-288C, the Department will refund the amount withheld and paid over to the Department, which exceeds the tax on the gain. The transferor/seller must still file a Hawaii income tax return after the end of the tax year, report the entire income for the year (from other sources as well as the transaction), and pay any additional tax due on the income or request a refund.

¹⁷ Section 231-34, HRS.

¹⁸ Section 231-36, HRS.

The chart below summarizes the forms currently used. Please refer to the forms and their instructions for more information.

Form:	Completed by:	Given to:	Purpose of the Form:
Forms Used to Claim an Exemption or Reduced HARPTA Withholding			
Form N-289	Transferor/Seller	Transferee/Buyer	To inform transferee/buyer that withholding is not required because: (1) transferor/seller is a resident, or (2) an IRC nonrecognition provision is applicable (e.g., IRC section 1031 exchange), or (3) the property has been used by the transferor/seller as a principal residence for the year preceding the date of the transfer and the amount realized for the property does not exceed \$300,000.
Form N-288B	Transferor/Seller	Department of Taxation	To apply for a withholding waiver or adjustment because: (1) no gain will be realized, or (2) there will be insufficient proceeds to pay the withholding. If approved by the Department, the transferor/seller must give a copy of the approved form to the transferee/buyer.
Forms Used to Pay HARPTA Withheld to the Department of Taxation			
Form N-288	Transferee/Buyer	Department of Taxation	Use Form N-288 to report the total amount withheld from all transferors/sellers and one Form N-288A to report withholding information for each transferor/seller. Attach Form N-289 and/or Form N-288B, if applicable. See the instructions for Form N-289 and N-288B.
Form N-288A	Transferee/Buyer	Department of Taxation (Copy A); Transferor/Seller (Copy B)	
Forms Used to Obtain a Refund of HARPTA Withheld			
Form N-288C	Transferor/Seller	Department of Taxation	Use Form N-288C to apply for a tentative refund of the withholding.**
Form N-15, N-30, or N-40	Nonresident Transferor/Seller	Department of Taxation	Use Form N-15, N-30, or N-40 to obtain a refund of the withholding.**
**The transferor/seller is required to file a Hawaii income tax return on Form N-15, N-20, N-30, N-35, or N-40, whichever is applicable, after the end of the tax year to report the sale or other disposition of Hawaii real property regardless of whether withholding is required.			

For more information on the withholding of tax on the disposition of Hawaii real property, see Tax Facts 2010-01, Understanding HARPTA.

Current forms and other tax information may be downloaded from the Department's website at: tax.hawaii.gov. You may also request a tax form by calling the Department's customer service representatives at 808-587-4242, or toll-free from the neighbor islands and continental U.S. at 1-800-222-3229.

FREDERICK D. PABLO
Director of Taxation

HRS Section Explained: 235-68
TIR Nos. 90-14 and 91-7 are superseded

NOTE: This Tax Information Release is a publication that provides general information on tax subjects of current interest to taxpayers and is not a substitute for legal or other professional advice. The information provided in this publication does not cover every situation and is not intended to replace the law or change its meaning. Furthermore, the information in this publication is subject to change without notice due to changes in the law or rules, judicial decisions, or changes in official Department positions.