TAX FACTS 2010-1

Understanding HARPTA

This Tax Facts provides guidance on the withholding of tax on the disposition of Hawaii real property by nonresident persons. This withholding of tax is commonly referred to as "HARPTA," which stands for the Hawaii Real Property Tax Act. As used in this Tax Facts, the person disposing of the real property is referred to as the "seller" and the purchaser of the real property is referred to as the "buyer." All references to the Internal Revenue Code (IRC) are to the IRC of 1986, as amended. Hawaii conforms to the federal income tax provisions for the IRC sections referenced in this Tax Facts. References to "husband and wife" are also references to "same-sex married couples" and "civil union partners."

The following answers common questions about HARPTA.

1 What is HARPTA?

Under HARPTA (section 235-68, Hawaii Revised Statutes (HRS)), every buyer is required to withhold and pay to the Department of Taxation (Department) 7.25% of the amount realized on the disposition of Hawaii real property. The buyer must pay the amount withheld to the Department 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.

HARPTA is similar to the federal Foreign Investment in Real Property Tax Act of 1980 (FIRPTA). The intent of HARPTA is to make sure that nonresident persons comply with Hawaii's Income Tax Law.

2 When does HARPTA apply?

HARPTA applies when there is a disposition of Hawaii real property. A common misperception is that HARPTA does not apply when the seller is a Hawaii resident. HARPTA does apply when the seller is a Hawaii resident, but the buyer is not required to withhold if the seller gives the buyer Form N-289, Certification for Exemption from the Withholding of Tax on the Disposition of Hawaii Real Property, stating that the seller is a Hawaii resident. See question 31. If the seller does not give Form N-289 to the buyer, the buyer is required to withhold, even if the buyer knows that the seller is a Hawaii resident. If the seller gives Form N-289 to the buyer, but the buyer knows that it is false, the buyer is required to withhold.

Example 1: Seller is a Hawaii resident but does not believe that he is required to file and pay Hawaii income taxes. Seller enters into a sales agreement to sell Hawaii real property to his brother, who knows that Seller is a Hawaii resident. Seller refuses to give Form N-289 to Buyer. Buyer is required to withhold 7.25% of the amount realized. If Buyer fails to do so, Buyer is liable for the amount that should have been withheld, even though Buyer knows that Seller is a Hawaii resident. See question 8.

Example 2: Seller is not a Hawaii resident but gives Form N-289 to Buyer stating that he is a Hawaii resident. Buyer knows this is false. Buyer is required to withhold 7.25% of the amount realized. If Buyer fails to do so, Buyer is liable for the amount that should have been withheld.

3 What is real property?

Real property is defined in section 231-1, HRS, as "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 3: 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 4: 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 question 19.

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4 Who is a nonresident?

A nonresident is any person 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 (TIR) No. 97-1, "Determination of Residence Status;"

(2) Corporation incorporated or granted a certificate of authority under chapter 414, 414D, or 415A, HRS;

(3) Partnership formed or registered under chapter 425 or 425E, HRS;

(4) Foreign partnership qualified to transact business pursuant to chapter 425 or 425E, HRS;

(5) Limited liability company formed under chapter 428, HRS, or any foreign limited liability company registered under chapter 428, HRS. If a single member limited liability company has not elected to be taxed as a corporation, the single member limited liability company will be disregarded and the sole member is considered the seller;

(6) Limited liability partnership formed under chapter 425, HRS;

(7) Foreign limited liability partnership qualified to transact business under chapter 425, HRS;

(8) Trust where the trustee, or other fiduciary, is a Hawaii resident or the administration of the trust is carried on in Hawaii; or

(9) Estate of a resident decedent where a Hawaii court appoints a personal representative or administrator and the administration of the estate is carried on in Hawaii.

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. The amount withheld and paid to the Department by the buyer is an estimated tax payment made for the seller. The buyer is acting as a withholding agent. When the seller files a Hawaii income tax return to report the sale (and any other Hawaii income), the amount of any taxes due is reduced by the amount that was withheld and paid to the Department. If the amount paid is more than the amount of the tax liability, the seller will receive a refund of the overpaid amount. If the amount paid is less than the amount of the tax liability, the seller must pay the balance due.

6 How much is withheld?

The buyer is required to withhold 7.25% of the amount realized on the disposition of Hawaii real property.

7 How can I get a refund?

There are two ways that you can get a refund if the amount withheld is more than the amount of tax that will be due on the sale. First, you can get a refund when you file a Hawaii income tax return after the end of the year.

Second, if the Hawaii income tax return for the year of sale is not yet available, you can apply for a tentative refund by filing Form N-288C, Application for Tentative Refund of Withholding on Dispositions by Nonresident Persons of Hawaii Real Property Interests. For example, you may file Form N-288C if you sold your house in the middle of the year since the income tax return for the year of sale will not be available until after the end of the year. Even if you receive a refund by filing Form N-288C, you must still file a Hawaii income tax return after the end of the year to report the sale and any other Hawaii income, and to pay any balance due or request a refund.

8 Who is responsible for withholding under HARPTA?

The buyer is required to withhold 7.25% of the amount realized on the disposition of Hawaii real property. If the buyer fails to do so, the buyer is liable for the amount that should have been withheld. See questions 15 and 31.

9 When is the HARPTA payment due?

The buyer must submit Forms N-288 and N-288A with the withheld amounts to the Department by the 20th day after the transfer date. Failure to file Forms N-288 and N-288A or to timely pay the amount due may result in penalties and interest.

10 What is the transfer date?

The transfer date is the date the sale closes and title to the property passes from the seller to the buyer.

11 Is the amount realized different from the sales price?

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

Example 5: Seller and Buyer enter into a sales and purchase agreement. Buyer purchases Seller's apartment building for $3,000

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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 6: Seller and Buyer enter into a sales and purchase agreement. Buyer purchases Seller's home for $100,000 cash. In addition, 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?

Generally, a disposition means a sale. However, many other transactions may also qualify as dispositions, including exchanges, liquidations, redemptions, gifts, transfers, and capital contributions. A disposition may occur even if the transaction results in no current recognition of gain or loss. For more information, see federal Publication 544, "Sales and Other Dispositions of Assets."

13 Does HARPTA apply to short sales and foreclosures?

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

A short sale occurs when a lien holder and property owner agree to a transaction where 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 seller may have cancellation of debt income, depending on the circumstances. See question 28.

Even though 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 the sale and the lien holders in full. See question 22. The seller must still file a Hawaii income tax return for the year of disposition.

14 How do I report installment payments on an agreement of sale?

HARPTA applies to all agreements of sale regardless of the date of the execution of the agreement. HARPTA must be withheld on each payment on an agreement of sale the buyer makes to the seller. The withholding requirement applies only to amounts attributed to the principal and does not apply to any interest amounts.

Besides withholding a portion of each payment, the buyer and seller may agree to withhold on the entire amount realized by the seller (excluding interest amounts) when the agreement of sale is executed or from the first payment due, or to withhold the annual amount of the tax from the first payment of each year for the term of the agreement of sale. The withheld amounts are due to the Department by the 20th day after payments are made.

15 What if I will not realize a gain on the disposition of my Hawaii property?

If you will not realize a gain on the disposition of your Hawaii property, you may file Form N-288B, Application for Withholding Certificate for Dispositions by Nonresident Persons of Hawaii Real Property Interest, to apply for a withholding certificate that eliminates the amount to be withheld by the buyer. You must submit supporting documentation to show that there will be no gain realized. 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).

You must file Form N-288B with the Department at least 10 working days prior to the date of transfer or it will not be approved. Even if a withholding certificate is granted by the Department because there is no gain realized on the disposition, you must still file a Hawaii income tax return for the year of disposition.

16 What kind of documentation is acceptable?

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

17 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 reduced by the

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full amount of depreciation allowable even if you did not claim depreciation that you were entitled to deduct. For more information on depreciation, see federal Publication 946, "How to Depreciate Property."

18 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 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 the property. For more information, see federal Publication 551, "Basis of Assets."

Example 7: In Year 1, Seller purchases a home for his residence. He replaces the wall-to-wall carpet with new carpeting. In Year 10, 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 8: Same facts as Example 7, except that 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 because it is no longer evident in the home. However, the cost of the hardwood floors may be added to the basis.

Example 9: Same facts as Example 8, except that Seller in Year 6 had to repair a portion of the hardwood floor due to a water leak. The cost of 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.

19 Does the cost of furnishings sold with my home increase the basis of my home?

If the furnishings are removable without incurring substantial damage to the home, the cost of the furnishings does not increase the basis of the home. 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. A sale of real property and its furnishings are really two sales: (1) a sale of the real property, and (2) a sale of the furnishings. If the seller cannot document the value of the furnishings and the sales agreement does not apportion the sales price between the real property and the furnishings, the amount of the sales price assigned to the furnishings is zero. If the furnishings were not used in a trade or business, any loss from the sale of the furnishings is a personal loss and is not deductible. See federal Publication 523, "Selling Your Home."

Example 10: In year 1, Seller buys a condominium for her personal summer residence. She purchases new appliances, including a washer, dryer, range, refrigerator, and air conditioner. These may be removed without damaging the condominium. In Year 5, Seller sells the condominium, including the appliances. The cost of the appliances does not increase the basis in the condominium, and the amount of the sales price assigned to the appliances is zero. Seller may have a loss on the sale of the appliances, but the loss is personal and does not reduce the amount of gain on the sale of the condominium.

Example 11: In year 1, Seller buys a condominium for her personal summer residence. She also purchases a Picasso painting for $500,000 to display in the residence. The painting may be removed without damaging the condominium. In Year 5, Seller sells the condominium, including the Picasso. The 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 sales price assigned to the Picasso is not included in determining the amount that is required to be withheld. There are two sales agreements: one for the sale of the real property and one for the sale of the Picasso. HARPTA applies to the sale of the real property, but not to the sale of the Picasso. Seller must still file a Hawaii income tax return for the year of disposition to report the sale of the condominium and the Picasso painting, and any other Hawaii income.

20 As the surviving spouse who is a resident of a community property state, can I claim a stepped-up basis under IRC section 1014(b)(6) for my one-half interest in the property?

Generally, you may not take a stepped-up basis for your one-half interest in the property. However, Hawaii has enacted the Uniform Disposition of Community Property Rights at Death Act ("UDCPRDA"), which is found in Chapter 510, HRS. UDCPRDA generally preserves the community property nature of the property, unless the couple has taken some action to sever community property rights.

With respect to real property located in Hawaii and purchased by the married couple while residing in a community property state, UDCPRDA, section 510-22, HRS, establishes a rebuttable presumption that such real property, and whose title to the real property in Hawaii is taken in a form which created rights of survivorship, is presumed not to be community property. Because this presumption is rebuttable, it may be overcome by clear and convincing evidence that the married couple intended such property to be community property. For instance, the deed may say that title is held "jointly, with rights of survivorship, and intended to be community property." Other written documentation, contemporaneously executed at the time of the purchase of the real property, may also be acceptable. For example, the Deposit Receipt Offer Acceptance (DROA) for the purchase of the property may

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state that title will be held "jointly, with rights of survivorship, and intended to be community property." If the rebuttable presumption can be overcome with such clear and convincing evidence, and provided that at least one-half of the entire community interest is included in the deceased spouse's gross estate, the surviving spouse's interest is treated as property acquired from the deceased spouse and therefore there is a full basis step-up due to the unlimited marital deduction of IRC section 2056. The treatment for income tax must, however, match the treatment for the estate tax.

If such written documentation does not exist, however, the presumption of section 510-22, HRS, applies, such that the property is not held as community property and the basis for the real property is one-half of the cost of the real property plus one-half of the fair market of the real property at the date of death (or, if applicable, one-half of the value of the property determined using the alternative valuation date).

Example 12: Married taxpayers purchase a residence while residing in Hawaii. They subsequently move to California, a community property state. After several years, Spouse dies unexpectedly, and the Surviving Spouse decides to sell the Hawaii residence. Surviving Spouse may not claim a full step up in basis, since the property was not purchased during a time in which the community property laws of California apply.

Example 13: Married taxpayers reside in Texas, a community property state, and decide to purchase a winter residence in Hawaii. In purchasing the property, the taxpayers in the DROA specified that they intend to hold the property as community property. The broker representing them informed them, however, that title to the property could not be held as such since Hawaii is not a community property state. They therefore hold the property as joint tenants with a right of survivorship. After several years, Spouse dies unexpectedly, and the Surviving Spouse decides to sell the Hawaii winter residence. At least one half of the value of the winter residence was included in the Hawaii estate tax return. The surviving spouse is entitled to a full step up in basis under UDCPRDA since the Surviving Spouse has overcome its presumption by producing the original DROA.

Example 14: Married taxpayers reside in a community property state whose laws provide that, unless shown to the contrary, any property acquired using community property funds is considered community property. The taxpayers sell a piece of community property real estate and use those funds to purchase a summer home in Hawaii. After several years, Spouse dies unexpectedly, and the Surviving Spouse decides to sell the Hawaii winter residence. At least one half of the value of the summer residence was included in the Hawaii estate tax return. The surviving spouse is entitled to a full step up in basis as the presumption that the parties intend to hold the property as community property applies.

21 Does Hawaii conform to IRC section 121?

Hawaii conforms to IRC section 121, which allows a seller to exclude up to $250,000 ($500,000 if married and filing a joint return) of the gain on the sale of the seller's principal residence. The exclusion applies if all of the following are true:

(1) The seller owned the home for at least two years during the five-year period ending on the date of the sale;

(2) The seller lived in the home as a principal residence for at least two of the years the seller owned the home during the five-year period ending on the date of the sale. The two years of residence can fall anywhere within the 5-year period. It does not have to be continuous. The two years may consist of 24 months or 730 days. A vacation or other short absence counts as time lived in the home;

(3) The seller did not acquire the home through a like-kind exchange (1031 exchange) during the past five years; and

(4) The seller did not exclude gain on another home sold during the two years before the current sale.

The $500,000 exclusion applies only if all of the following are true: (1) the taxpayers are married and file a joint return for the year of sale, (2) either the taxpayer or the taxpayer's spouse meets the ownership requirement, (3) both the taxpayer and the taxpayer's spouse meet the residence requirement, and (4) neither the taxpayer nor the taxpayer's spouse excluded gain on another home sold during the two years before the current sale.

A seller who does not qualify for the $250,000 or $500,000 exclusion may qualify for a partial exclusion if the sale of the home is due to (1) a change in the seller's workplace location, (2) health issues, or (3) an unforeseeable event. See federal Publication 523, "Selling Your Home," for more information.

A seller who wants to eliminate the amount of withholding required because of the gain exclusion must file Form N-288B along with required documentation. **If any amount of gain remains after applying the exclusion, Form N-288B cannot be used.** The buyer is required to withhold the full 7.25% of the amount realized. Even if a withholding certificate is issued, the seller must still file a Hawaii income tax return for the year of disposition.

Example 15: Husband and Wife purchase a home in 1957. In 2018, 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 2020, they sold their home after 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. Because Husband and Wife are

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entitled to the IRC section 121 exclusion, the amount required to be withheld under HARPTA may be eliminated if they provide the buyer an approved Form N-288B. Husband and Wife must still file a Hawaii income tax return for the year 2020.

22 What if I have insufficient funds from the sale to pay all my outstanding mortgages and the costs of sale?

If you will have insufficient proceeds from the sale to pay the withholding in full, you may file Form N-288B to apply for a withholding certificate that reduces or eliminates the amount to be withheld by the buyer. You must submit supporting documentation such as a tentative closing statement. You must file Form N-288B with the Department at least 10 working days prior to the date of transfer or it will not be approved. Even if a withholding certificate is granted by the Department based upon insufficient proceeds, you must still file a Hawaii income tax return for the year of disposition.

23 Can a commissioner appointed by the court to sell a house in foreclosure submit a Form N-288B?

A commissioner or other duly appointed fiduciary, acting within the scope of the commissioner's 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 the commissioner has personal knowledge of the situation. A commissioner in a foreclosure or similar sale is an agent for the 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. A commissioner appointed to act on behalf of the seller is **not** the owner of the real property being sold and title to the property does not transfer from the seller to the commissioner when the commissioner is appointed by the court. The seller remains the owner of the property until it is sold, and must file a Hawaii income tax return to report the sale and any other Hawaii income, and to pay any tax due.

24 Am I required to withhold if a lender sells me property?

You are not required to withhold if the lender is one of the following and is subject to the franchise tax under chapter 241, HRS:

- Bank,
- Building and loan association,
- Financial services loan company,
- Financial corporation,
- Small business investment company,
- Trust company,
- Mortgage loan company,
- Financial holding company,
- Subsidiary of a financial holding company, or
- Development company.

Section 235-9, HRS, provides that these entities are not taxable under Hawaii's Income Tax Law. Therefore, the HARPTA withholding does not apply to these entities since the withholding is an income tax provision. These entities are not required to provide you with a Form N-288B or Form N-289.

25 Am I required to withhold if a government agency sells me property?

You are not required to withhold if the seller is a government agency. Federal (including Fannie Mae and Ginnie Mae), state, municipal, and county government agencies are not considered taxable entities for Hawaii income tax purposes. Therefore, the HARPTA withholding does not apply to government agencies. Government agencies are not required to provide you with a Form N-288B or Form N-289.

26 Can an escrow company apply for a refund of the withholding?

No. The escrow company cannot apply for a refund of the withholding even if the escrow company made an error and paid a withholding amount to the Department when withholding was not required. As noted in question 5, a HARPTA payment made to the Department is an estimated tax payment and credited to the seller's account. Once payment is made to the Department, only the seller can request a refund of the amount withheld. The seller can apply for a tentative refund by filing Form N-288C. See question 7. The Department cannot process a refund request submitted by any other party, including the escrow company.

27 Do I owe taxes if the amount of my secured indebtedness exceeds the sales price?

Even if your secured indebtedness exceeds the sales price, you would owe taxes if you have a taxable gain. 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

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no capital improvements are made to the property. Under certain conditions, a cancellation of debt may also result in taxable income.

Example 16: 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. 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 to pay for personal expenses unrelated to the condominium. Five years later, 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. Taxpayer made no other improvements to the condominium. 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 seller is required to file a Hawaii income tax return for the year of sale and to pay the tax due, even though the seller did not receive any proceeds of the sale. HARPTA still applies, so the buyer is required to withhold, unless the seller gives the buyer an approved Form N-288B due to insufficient proceeds.

28 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 Form 1099-C, Cancellation of Debt. For more information, see federal Publication 4681, "Canceled Debts, Foreclosures, Repossessions, and Abandonments."

Example 17: Taxpayer purchases a condominium for Taxpayer's principal residence for $300,000, paying $15,000 down and the balance through a new first mortgage loan of $285,000. The loan is recourse, meaning that Taxpayer is personally liable for the mortgage. When the remaining balance of the loan is $280,000, Taxpayer defaults on the loan. The lender accepts Taxpayer's voluntary conveyance of the condominium in exchange for canceling the loan. Similar condominiums are selling for $230,000 at the time the conveyance to the lender is executed.

The taxpayer may 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. In addition, the transaction is a disposition and is treated as a sale. Taxpayer has a loss of $70,000 (fair market value of $230,000 minus the adjusted basis of $300,000), which is nondeductible because it is a personal loss.

29 Is cancellation of debt income always taxable?

Certain situations may reduce or eliminate the taxable amount on the cancellation of debt income. 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, IRC section 108 provides relief from cancellation of debt income for certain homeowner-occupants until December 31, 2017. 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.

30 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. The lender cannot pursue you personally in case of default. Because sellers 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, there is generally no cancellation of debt income.

Example 18: Taxpayer purchases a condominium for Taxpayer's principal residence for $300,000, paying $15,000 down and the balance through a new first mortgage loan of $285,000.

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The loan is non-recourse, meaning that Taxpayer is not personally liable for the mortgage. When the remaining balance of the loan is $280,000, Taxpayer defaults on the loan. The lender accepts Taxpayer's voluntary conveyance of the condominium in exchange for canceling the loan. Similar condominiums are selling at $230,000 at the time the conveyance to the lender is executed.

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. The transaction is a disposition and is treated as a sale. The amount received is the amount of the cancelled debt. Taxpayer has a loss of $20,000 (amount received through cancellation of debt of $280,000 minus the adjusted basis of $300,000), which is nondeductible because it is a personal loss.

31 Are there any exceptions to the withholding requirements?

Yes. Withholding is not required if the seller gives to the buyer Form N-289 stating the seller's taxpayer identification number and:

(1) The seller is a Hawaii resident person;

(2) That by reason of a nonrecognition provision of the IRC (which Hawaii conforms to), or the provisions of any United States treaty, the seller is not required to recognize any gain or loss with respect to the transfer. The seller must provide a description of the transfer and a summary of the law and facts which support the claim of nonrecognition; or

(3) For the year preceding the date of the transfer, the property has been used by the seller as a principal residence and the amount realized for the property does not exceed $300,000. Note: This differs from FIRPTA, which exempts a transaction if the buyer purchases real estate which will be used as the buyer's principal residence and the amount realized is not more than $300,000.

32 What are some of the nonrecognition of gain or loss provisions that Hawaii conforms to?

Common nonrecognition provisions include:

- IRC section 1031 "like-kind" exchange,
- Transfers by gift,
- Transfers by bequest, and
- Transfers incident to divorce.

In all these instances the seller must still give the buyer Form N-289.

The most common nonrecognition provision in real estate is the IRC section 1031 exchange, which allows the 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. The seller does not need to replace the property with another property in Hawaii. 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. There can also be both deferred and recognized gain in the same transaction when a taxpayer exchanges property for like-kind property of lesser value. **If any amount of gain is recognized in an IRC section 1031 exchange, Form N-289 cannot be used to obtain an exemption from the withholding.**

Example 19: Investor purchases an apartment building for $250,000. Five years later, in a qualified IRC section 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. Form N-289 cannot be used to obtain an exemption from the withholding. The buyer is required to withhold the full 7.25% of the amount realized, which includes the value of the stock received.

33 Where can I get additional information on HARPTA?

For additional information on HARPTA, see TIR 2017-01, "Withholding of State Income Taxes on the Disposition of Hawaii Real Property," or call the Department's technical section at 808-587-1577. Forms and publications referenced in this Tax Facts are available on our website at **tax.hawaii.gov**. Forms and publications can be mailed to you by calling 808-587-4242 or toll-free at 1-800-222-3229.

Where to Get Forms and Information
Website: tax.hawaii.gov
Telephone: 808-587-4242
Toll-Free: 1-800-222-3229
Telephone for the hearing impaired: 808-587-1418
Toll-Free for the hearing impaired: 1-800-887-8974

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