

by Mike Garcia and Michael Vieira

A foreclosing mortgagee (“Lender”) must be prepared to respond to a buyer’s withholding obligations under 26 U.S.C. §1445 (“FIRPTA Withholding”) and under HRS §235-68 (“HARPTA”) (together “Withholding”) or risk losing 15% of the sale price at closing. A Hawaii foreclosure case that concluded on August 11, 2014 illustrates the need for the Lender to have a plan of action for dealing with FIRPTA Withholding and HARPTA.

In *J.P. Morgan v. Tsung-Jung Chen, et al.*, Civil No. 11-1-2539-10 (First Circuit

*avoid FIRPTA and HARPTA remittances or require that the plaintiff-lenders add, in their drafts of the Court’s order, that if bona fide exemptions cannot be provided by the plaintiff-lender, the escrow is authorized to withhold the required sums from the proceeds and to send these to the IRS and the State...*



## Foreclosing Mortgagee Can't Ignore HARPTA & FIRPTA Withholding Requirements

Court, State of Hawaii), the Lender almost lost \$52,200 of the \$348,000 foreclosure sale proceeds because of the Withholding requirements. The Lender believed that the \$52,200 to be withheld by buyer through escrow and sent to the tax authorities would ultimately be credited to the Lender. The Lender did not realize that the tax authorities would credit the \$52,200 to the property owner<sup>2</sup> and not the Lender.

In the *J.P. Morgan* case, the Lender apparently had no plan for dealing with Withholding, so it was unprepared to deal with buyer’s Withholding instructions to escrow. The ensuing chaos and delays to closing finally led the foreclosure commissioner to file a Request for Instructions, where the Commissioner provided the court with the following conclusion:

*... CONCLUSION - The questions about FIRPTA and HARPTA which have surfaced in this action do serve one salutary purpose – the avoidance of a pitfall for other commissioners as well as plaintiff-lenders and buyers at auction. Your Commissioner respectfully suggests the Court require all plaintiff-lenders to provide the information required to*

Commissioner’s Request for Instructions filed June 26, 2014, at 14 (available at <http://www.ashfordwriston.com/foreclosure.htm>).

(A review of this document would allow reader to discover the extent to which these Withholding requirements can be an expensive disruption to the foreclosure process.)

In order to understand how Lender could have avoided the chaos caused by buyer’s HARPTA/FIRPTA Withholding obligations, let us briefly examine the Hawaii foreclosure process and these buyer withholding requirements.

### HAWAII JUDICIAL FORECLOSURES

The foreclosure process forces a sale of property in order to satisfy the debt owed to Lender. In Hawaii judicial foreclosures, a commissioner is appointed to preserve, market, and sell the property at the highest possible price. At the foreclosure auction, the highest bidder is required to pay a cash down payment. Thereafter, the mortgagee files a motion

to confirm the sale. At the confirmation hearing, the court may reopen bidding for higher bids.

The court’s confirmation of the sale is the equivalent of a valid contract for sale and, generally, the confirmed buyer must complete the purchase within 35 days. If a third-party is the highest bidder, an escrow account is typically opened. Upon closing, the Commissioner delivers a Commissioner’s Deed to convey title to the buyer.

### FIRPTA WITHHOLDING REQUIREMENTS

In essence, FIRPTA Withholding requires a buyer<sup>3</sup> of U.S. real property<sup>4</sup> to withhold and send to the Internal Revenue Service (“IRS”) an amount equal to 10% of the amount realized by the “transferor”<sup>5</sup> (hereinafter also

referred to as the “seller”), unless the buyer is provided with some document to allow the buyer to evidence to IRS that an exemption to buyer’s withholding obligation has been met. Unless a bona fide exemption applies, a failure to withhold may subject the buyer to personal liability for the 10% FIRPTA amount plus penalties and interest if the property owner turns out to be a foreign owner.

A buyer’s liability for FIRPTA withholding applies to all real property sales in the United States, including foreclosure sales. It even applies to a Lender who credit bids on foreclosure property and successfully becomes the buyer of the property (despite the fact that there is insufficient cash to send 10% to the IRS).

The FIRPTA Withholding obligation was created to enforce a tax on a foreign owner of real property who may otherwise be outside the jurisdiction of the IRS and fail to report the sale. It ensures that the IRS is informed of the sale and is holding onto some of the foreign property owner’s money so that the foreign owner is forced to file an income tax return the following year to report the real property sale and either obtain a refund of some portion of the amount withheld or pay the balance of the tax shortfall.

This enforcement mechanism for collection of tax on foreign sellers is analogous to the enforcement mechanism for collection of tax on employees’ compensation. Under both enforcement mechanisms, the IRS deputizes as a withholding agent (without pay) the person controlling the cash to be paid to the other party and requires that person to pay a portion of the cash to IRS, which the IRS then credits to the seller or employee, as the case may be, and not the withholding agent.

There are several exemptions to a buyer’s withholding obligation, but the buyer must be careful to obtain the appropriate document that establishes the exemption. Otherwise, the IRS could hold the buyer personally liable for the buyer’s failure to timely remit the funds if the property owner turns out to

be a foreign owner. Following are the exemptions:

**1. Transferor Furnishes Non-Foreign Status Certification.** No withholding is required if a buyer receives a seller’s certification stating, under penalty of perjury, that the seller is not a foreign person, together with seller’s federal taxpayer identification number (“TIN”) and address. The buyer must retain the certification for at least 5 years. This is the most important exemption because the other exemptions would normally be necessary only if the seller (*i.e.*, the property owner) is a foreign seller unable to furnish the Non-foreign Status Certification.

**2. Purchase Price for Residence.** No withholding is required if the sales price for the property does not exceed \$300,000 and the property is acquired by an individual buyer for use by the buyer as a residence. Note, however, that a buyer remains liable for failure to withhold and remit the 10% if a buyer does not, in fact, reside at the property. Therefore, this exemption should not be relied upon by a buyer unless absolutely necessary. It is always better for a buyer to obtain the seller’s non-foreign status certification or to withhold and send to the IRS the required 10%.

**3. Transferee Receives IRS Withholding Certificate.** The withholding amount may be reduced or eliminated pursuant to a qualifying statement issued by the IRS (the regulations refer to the statutory term “qualifying statement” as “withholding certificate”). The IRS will issue a “withholding certificate” only in cases where: (i) the seller is exempt from U.S. tax, (ii) an agreement for the payment of tax is entered into with the IRS, or (iii) reduced withholding is appropriate.

**4. Notice of Non-recognition Treatment.** No withholding is required if the buyer: (i) receives the appropriate notice from the transferor that the transferor is not required to recognize gain or

loss with respect to the transfer in compliance with the specific requirements of Treasury Regulations §1.1445-2(d)(2) and (ii) provides a copy of the notice to IRS within 20 days of the property transfer.

**5. Special Procedural Rules Applicable to Foreclosures.** There are alternative procedures that would allow a buyer to remit to the IRS only that portion of the foreclosure sale proceeds, if any, that would otherwise go to the property owner, but these procedures require: (i) the foreclosing mortgagee to initiate certain critical determinations to be in a position to provide buyer with timely written information and (ii) the buyer to assume some tax risk in agreeing to cooperate with foreclosing mortgagee in filing, timely and correctly, certain formal notices.

## HARPTA REQUIREMENTS

After FIRPTA Withholding became law, many states determined that a withholding tax mechanism similar to FIRPTA Withholding would provide an effective way to enforce state income tax on nonresident sellers of real estate located within their borders. Consequently, Hawaii adopted a withholding tax mechanism very similar (but not identical) to FIRPTA with respect to the disposition of real property located in the State of Hawaii.<sup>6</sup>

HARPTA requires a buyer of Hawaii real property to withhold and send to the Hawaii Tax Department (“HTD”) an amount equal to 5% of the amount realized by the “transferor” (hereinafter also referred to as seller), unless the buyer is provided with some document to allow buyer to evidence to HTD that an exemption to buyer’s withholding obligation has been met.

As with the FIRPTA Withholding rules, there are several exemptions to a buyer’s obligation to withhold, but the buyer must be careful to obtain the appropriate document that establishes the exemption. Otherwise, the HTD can hold the buyer personally liable for failure to timely remit,<sup>8</sup> regardless

whether the property owner is or is not a Hawaii resident.<sup>9</sup> Following are the HARPTA exemptions:

**1. Transferor Furnishes Hawaii Resident Certification.**

No withholding is required if the seller furnishes to the buyer a properly completed Form N-289 to certify that the seller is a Hawaii resident.<sup>10</sup>

**2. Transferor's Affidavit of Principal Residence.**

No withholding is required if: (i) the sales price for the property does not exceed \$300,000 and (ii) the seller furnishes the buyer with a properly completed Form N-289 to certify that the seller used the property as a principal residence for the year preceding the date of the transfer.

**3. Transferee Receives Hawaii Withholding Certificate.**

The withholding amount may be reduced or eliminated pursuant to a "withholding certificate" issued by HTD. The HTD will issue a "withholding certificate" only in cases where: (i) there will be insufficient proceeds to pay the 5% after payment of all costs, including selling expenses and the amount of any mortgages or liens secured by the property or (ii) the seller will not realize any gain on the sale.

**4. Notice of Non-recognition Treatment.**

No withholding is required if the buyer receives from the seller a properly completed Form N-289 stating: (i) that the transferor is not required to recognize gain or loss with respect to the transfer and (ii) briefly describing the transfer and summarizing the law and facts supporting the transferor's claim.

**APPLICATION OF HARPTA/  
FIRPTA WITHHOLDING TO  
FORECLOSURE SALES**

In order to avoid liability, a knowledgeable buyer will likely instruct escrow to withhold 15% of the gross proceeds to satisfy the HARPTA and FIRPTA Withholding requirements. The Lender may avoid the possible loss of 15% of

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the gross proceeds only if prepared to deal with buyer's obligation to withhold. The first step is to ensure that Lender retrieves the property owner's TIN before commencing the foreclosure process. The property owner's TIN will be needed to qualify for any bona fide exemption to HARPTA and FIRPTA Withholding (except for the \$300,000 Residence exemption). Without the TIN, the tax authorities could obtain 15% of the foreclosure sale proceeds.

In the *J.P. Morgan* case, the Lender did not have the property owner's TIN available, so there was no way to timely satisfy the buyer's legitimate concern about his liability to the IRS and the HTD for failing to withhold. Luckily for the Lender, the buyer decided not to pursue his contract rights and just wanted to cancel the transaction in light of the chaos and delays in closing, so the court resolved all issues raised by the commissioner in her Request for Instructions by simply allowing a new auction and approving Lender's credit bid to purchase the property. (See Final Court Order and Judgment dated 8/11/2014 at <http://www.ashfordwriston.com/foreclosure.htm>)

Important to note is that a Lender's credit bid subjects a Lender-buyer to the HARPTA and FIRPTA Withholding requirements. More specifically, a Lender-buyer would need to: (i) address its potential liability for failing to withhold the 10% FIRPTA amount and (ii) obtain a "Withholding Certificate" from HTD (based on "insufficient proceeds") to eliminate its liability for the 5% HARPTA amount. Without the property owner's TIN, a Lender cannot be certain that the tax authorities will not obtain 15% of the foreclosure sale price.

## SUMMARY

The foreclosing mortgagee in the *J.P. Morgan* case (or any foreclosure case) could have avoided the chaos and possible loss of 15% of the foreclosure proceeds by: (i) retrieving the property owner's TIN before commencing the foreclosure process and (ii) developing a plan to satisfy the buyer's HARPTA and

FIRPTA Withholding obligations. There are different ways to eliminate a buyer's FIRPTA Withholding obligation, but the only way to eliminate a buyer's HARPTA withholding obligation in a foreclosure sale is to deliver to the buyer a "Withholding Certificate" issued by the HTD based on "insufficient proceeds." The important point to remember is that any foreclosing mortgagee must have a plan for eliminating a buyer's HARPTA and FIRPTA Withholding obligations prior to commencement of the foreclosure process.

<sup>1</sup> FIRPTA refers to the "Foreign Investment in Real Property Tax Act of 1980" which was codified in 26 U.S.C. § 897. FIRPTA was originally to be enforced by certain reporting requirements under 26 U.S.C. § 6039C. There were problems with this enforcement mechanism, so Congress enacted 26 U.S.C. § 1445 four years later in 1984 to enforce FIRPTA through a new withholding mechanism. Therefore, 26 U.S.C. § 1445, the mechanism to enforce FIRPTA, is being identified here as "FIRPTA Withholding."

<sup>2</sup> This article refers to the defendant as the "property owner" rather than as the "delinquent borrower" in order to emphasize that the capital gains tax consequences resulting from the foreclosure flows from defendant's status as a "property owner" rather than as a "borrower."

<sup>3</sup> This article deals only with foreclosure sales of real property, so it will limit its discussion of FIRPTA Withholding only to "buyers" of U.S. real property rather than the larger group of "transferees" who are obligated to withhold under 26 U.S.C. § 1445.

<sup>4</sup> FIRPTA Withholding applies to any disposition of a U.S. real property interest ("USRPI") and USRPI includes not only U.S. real property but also interests in U.S. corporations with substantial holdings of USRPI. However, this article deals only with U.S. real property (and not with other USRPIs).

<sup>5</sup> Since this article deals with foreclosure sales, it will intermittently use the term "seller" rather than the broader statutory term "transferor" utilized in 26 U.S.C. § 1445. Furthermore, note that the "amount realized by transferor" is defined in Treasury Regulation § 1.1445-1(g)(5) as "the sum of (i) [t]he cash paid, or to be paid, (ii) [t]he fair market value of other property transferred, or to be transferred, and (iii) [t]he outstanding amount of any

liability assumed by the transferee or to which the U.S. real property interest is subject immediately before and after the transfer." Therefore, in situations where a buyer is acquiring property in a foreclosure by a junior lienholder (*i.e.*, where buyer will take title to property subject to the senior lien), the buyer would be obligated to withhold and remit to the IRS not only 10% of his/her cash purchase price but also 10% of the amount of the senior lien that is not extinguished at closing.

<sup>6</sup> H.R.S. § 235-68(b).

<sup>7</sup> Since this article deals with foreclosure sales, it will intermittently use the term "seller" rather than the broader operative statutory term of "transferor" utilized in H.R.S. § 235-68. See also footnote 5 regarding situations where the plaintiff in a foreclosure action is a junior lienholder.

<sup>8</sup> Similar to FIRPTA Withholding, the unexcused (*i.e.*, without a document to evidence that an exemption applied) failure to withhold and remit to the HTD the 5% HARPTA amount would subject the buyer to personal liability for the 5% HARPTA amount plus penalties and interest.

<sup>9</sup> Note the contrast to a buyer's liability under FIRPTA Withholding and HARPTA. Under FIRPTA Withholding, a buyer would be liable to the IRS for an unexcused (*i.e.*, without a document to evidence that an exemption applied) failure to withhold only if the property owner turns out to be a foreign owner. Under HARPTA, a buyer would be liable to the HTD for an unexcused (*i.e.*, without a document to evidence that an exemption applied) failure to withhold regardless of the status of the property owner as a Hawaii resident or nonresident.

<sup>10</sup> Without the specific Form N-289 Certification, a buyer could be held liable to the HTD for failure to withhold the 5% HARPTA amount even if the seller (*i.e.*, the property owner) turns out to be a Hawaii resident.

*Manuel "Mike" Garcia is Tax Counsel at the Honolulu law firm of Ashford and Wriston, LLP and Michael Vieira is a partner at the same firm. Mike Garcia is the author of "The FIRPTA Withholding Guidebook" published by the American Bar Association last year. He is speaking on the subject of "HARPTA/FIRPTA Withholding in Foreclosures" at the Hawaii Bar Convention on October 24, 2014.*