

# LEGAL NOTES

## FROM THE DESK OF HAROLD CHU

Subprime loans are loans made to people with less than stellar credit. The recent crisis in subprime loans has caused a tightening of credit for everyone.

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The federal government in December, 2007 enacted legislation which provided relief to owners who had decided to give their homes back to the lender in lieu of foreclosure. The forgiveness of the debt by the lender is considered "phantom income". Previously, the owner of the home had to pay income tax on this phantom income, this forgiveness of the debt.

\* \* \*

Certain lenders have now arranged to allow for refinancing of loans to avoid foreclosure and other legal consequences. If you are having problems with a loan, you may wish to inquire into the possibility of refinancing your loan and whether this alternative is available for you and suitable for you.

\* \* \*

Our firm primarily represents landlords. Some of our landlord clients have encountered problems with not providing a receipt for the monthly rent. The Hawaii statute requires landlords to provide a receipt for each rental payment. Some landlords have found that a tenant when paying cash will later claim that rent was paid when it had not been paid. See the article in this newsletter for our suggestions as to how to deal with this problem.

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## Potential New Laws for Bed & Breakfast Lodgings Are Stalled or Pending

Bill 96 was pending before the City Council. Bill 96 would have reclassified bed and breakfast lodging and vacation rental homes as hotel and resort. This change would have significantly increased the assessed valuation for these properties and would have meant substantially higher taxes. For example, the real property taxes for a property worth \$600,000 would have been changed from \$1,974 per year to \$7,440 per year less any exemptions. The proposed Bill would have affected cottages and condominiums that were rented to vacationers for less than 30 days. There was concern that these accommodations would be subject to transient accommodations tax. Transient accommodations is defined by the Hawaii Revised Statutes as the furnishing of a room, apartment to transients for less than 180 consecutive days. Bill 96 passed the first reading and was referred back to the Budget Committee where it has languished.

Bed and breakfast operators were opposed to such a reclassification. Many of these owners argued the rentals are merely a supplement to their family income. The proponents of the Bill countered that these homeowners charged visitors like a hotel and therefore, they should pay the same tax rate as hotels. In addition, those opposed to bread and breakfast and vacation rentals argued the bed and breakfast operations cause nuisances, such as additional noise and parking problems in the neighborhood.

City & County Bills 6 and 7 were also being considered. One Bill would have repealed the present ban against bed and breakfast lodging, but would allow neighbors to block such lodging. A second Bill would have required the owners of such transient vacation units to include the permit number and the address in any advertisement. There would be fines for non-compliance. These Bills are pending and some consideration is being given to getting public comments on these proposed Bills.

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## Transfer of Out of State Properties

Clients often ask us to assist them with the transfer of real property located in another state. It is our recommendation that clients find counsel in the state where the real property is located. The reason for this is that the law where the real property is located is the controlling law.

While transfer of title documents can be similar, each state often has its own unique requirements. It has been our experience that the most cost efficient way of transferring title to real property located in another state is to find a real estate attorney who practices in that state. You can do so by searching the Internet. You can also contact the Hawaii State Bar Association's Lawyer Referral Information Service at (808) 537-9140 and ask for the telephone number of the referral organization in the state where the real property is located.

## Converting the Home Equity Into Cash

Clients often seek to convert the equity in their home into cash. The equity is the difference between the market value of the property and the amount of any outstanding claims against the property. The equity in the property increases if the property appreciates in value and/or if the obligations against the property are paid down.

There are three typical ways of converting the home equity into cash. These are:

1. Home equity line of credit
2. Home Equity loan
3. Reverse mortgage

We will discuss each of these alternatives.

### Home Equity Line of Credit

A home equity line of credit is where a lender extends you an amount of credit that you can draw on. It is like a checking account against which you can write checks. With a home equity line of credit, the interest rates charged typically can fluctuate. If interest rates are increasing, the monthly repayments will also increase, possibly to an amount that is beyond what was originally anticipated. The interest paid on a home equity line of credit is deductible if your home is given as security for the line of credit.

### Home Equity Loan

A home equity loan is when the homeowner borrows money and the owner's residential property is given as security. While the interest rates on these loans can be adjustable, there are also loans with a fixed rate interest. With a fixed rate loan, no matter what happens to the interest rates, the owner has the comfort of knowing that the monthly repayments will not change. The interest payments on such loans can be deductible, if it satisfies the Internal Revenue Code restrictions on the amount and other conditions. You should consult with your tax adviser about the applicable tax consequences before securing a home equity loan.

### Reverse Mortgage

In a reverse mortgage, the lender makes a loan or payments to the home owner. The owner must be 62 years or older. The loan is not due so long as the home is the primary residence for the owner. The loan becomes due when the owner sells the home or if the home is no longer the owner's primary residence.

If you are considering a reverse mortgage, you should thoroughly investigate the costs. The costs of a reverse mortgage are typically higher than with a tradi-

tional loan because interest is charged on an ever increasing loan amount. The owner may also wish to consider if a reverse mortgage is desirable if the owner's intentions are to leave the property to one's heirs.

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## Defer Capital Gains Tax With a 1031 Tax Free Exchange

Under normal circumstances, when you sell your investment property you have to pay tax on the gain. There is usually a gain when depreciation deductions are taken or if the property has appreciated in value during your ownership.

There is an exception to the capital gains tax. When you sell your business or investment real estate and replace it with a different business or investment property, it is possible to defer payment of the capital gains tax normally required on these sales. This can be done by complying with the provisions of Section 1031 Exchange of the Internal Revenue Code. A 1031 exchange can provide more proceeds for your next investment than if you simply reinvested the after-tax proceeds. This is because you will have more available money since you have deferred payment of the capital gains tax.

A 1031 Exchange is not a tax loophole. You must meet all the requirements of the Internal Revenue Code. Thus, you should consult with a tax expert when doing a 1031 exchange. You should also remember it is a deferral of the tax, not an avoidance of the tax.

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## Legislative Relief from Phantom Income

In our last newsletter, we discussed "phantom" income. People whose debts were forgiven by their lender had to pay income tax on the amount of the debt that was forgiven when they lost their residence through foreclosure. After our last newsletter was published, Congress enacted H. R. 3648 in December, 2007 a law which provides relief for people who would otherwise be subject to phantom income.

Under the new law, the phantom income will not be taxed in the year 2007, 2008 and 2010 if certain statutory requirements are met. The amount of debt excluded from tax is limited to two million dollars. There is, however, no free lunch. It should be noted that the Act reduces the bases of the principal residence by the amount of discharged debt excluded from gross income. You should check with your tax advisor as to how this may affect you.

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## Landlords Should Be Careful in Their Questions to Prospective Tenants

Landlords should be careful about the questions posed to a prospective tenant. A landlord's inquiry about the family size, the number of children, about elderly relatives staying with the tenant have been the basis for discrimination claims filed with the Hawaii Civil Rights Commission.

While many of these allegations are ultimately proven to be unfounded, landlords can spend thousands of dollars in defending themselves before the Hawaii Civil Rights Commission. In addition to the costs for defending such allegations, such disputes usually take months or years to resolve.

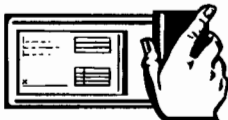
It is our recommendation that landlords look solely to the tenant's financial ability to pay. The law does not require landlords to rent to people who cannot pay the rent. Landlords should ask for prior references from the prospective tenants. Landlords should call those prior landlords and ask whether they would rent to the tenant again. The prior landlord's response or non-response often provides sufficient insight to decide whether the prospective tenant is a favorable prospect or one with whom the landlord might anticipate possible problems.

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## Landlords Should Provide a Receipt for the Rent Payment

Landlords are **required** by law to provide a receipt to tenants. There is a practical reason why the landlord should do so in addition to complying with state law.

Tenants who pay in cash and do not receive a receipt could argue payment was made when it had not been made. By providing a receipt, especially a receipt that has been initialed and acknowledged by the tenant, the landlord has proof and an arguable defense against such unfounded allegations by the tenant. The landlord should provide a receipt not only to comply with State law, but also to secure some proof against possible unfounded allegations by the tenants. The best proof is to require tenants to pay by check.



## Tightening Credit

In our previous newsletter, we referred to the tightening lending standards. What does this mean? Lenders are trying to minimize their risk by adopting tougher standards for borrowers to qualify for a loan. If you have less than good credit, it will probably be more difficult to qualify for a loan. It will be harder and more expensive to borrow money. Even consumers who have good credit will find that lenders will have less tolerance for risk and will require more documentation.

Borrowers who are looking for jumbo loans, which are mortgage of \$417,000 or more, will find that their gross monthly income must be higher to qualify for the mortgage.

We recommend buyers get prequalified **before** buying real estate. It is important for the buyer to know what they can qualify for before they begin their search for real properties. Tighter credit does not mean the end of the real estate market, but it will mean that you are unlikely to find no money down or low money financing. Lenders will be more conservative.

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## HUMOR

For those of you who watch what you eat, here's the final word on nutrition and health. It's a relief to know the truth after all those conflicting nutritional studies.



1. The Japanese eat very little fat and suffer fewer heart attacks than Americans.
2. The Mexicans eat a lot of fat and suffer few heart attacks than Americans.
3. The Chinese drink very little red wine and suffer few heart attacks than Americans.
4. The Italians drink a lot of red wine and suffer few heart attacks than Americans.
5. The Germans drink a lot of beers and eat lots of sausages and fats and suffer few heart attacks than Americans.

**CONCLUSION:** Eat and drink what you like. Speaking English is apparently what kills you.

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HUMOR

A man and his ever-nagging wife went on vacation to Jerusalem. While they were there, the wife passed away. The undertaker told the husband, "You can have her shipped home for \$5,000, or you can bury her here, in the Holy Land, for \$150." The man thought about it and told him he would just have her shipped home. The undertaker asked, "Why would you spend \$5,000 to ship your wife home, when it would be wonderful to be buried here and you would spend only \$150?" The man replied, "Long ago a man died here, was buried here, and three days later he rose from the dead. I just can't take that chance."



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