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DEPARTMENT OF TAXATION ANNOUNCEMENT NO. 2006-17

RE: Relating To The Application Of The County Surcharge Sourcing Rules To Cash Basis And Accrual Basis Accounting Method Taxpayers

The purpose of this Tax Announcement is to provide guidance on the application of the new county surcharge tax in Hawaii Revised Statutes (HRS) section 237-8.6, for cash basis and accrual basis taxpayers. Beginning January 1, 2007, section 237-8.6, HRS, imposes a county surcharge on the state general excise tax.

Under Internal Revenue Code section 451, gross income shall be included in the taxable year in which taxpayer received it unless otherwise provided by other accounting methods that the taxpayer used. Generally, cash basis accounting method taxpayers report their gross income in the taxable year in which payments are actually or constructively received. Generally, accrual basis accounting method taxpayers report their income in the taxable year in which all events that fix the right to receive the income have occurred and the amount of the income can be determined with reasonable accuracy. An accrual basis accounting method taxpayer recognizes income when an amount is paid, due or "earned", whichever occurs first. In general, income is earned when performance on the part of the taxpayer occurs, such as the transfer of property or the performance of services.

Gross proceeds from business transactions that occur prior to the effective date of the county surcharge could be subject to different tax rates depending on the timing of the payments received under the cash basis accounting method and on the outcome of the all events test under the accrual basis accounting method. Under the cash basis accounting method, gross proceeds from transactions occurring prior to January 1, 2007 will be subject to the 4.0% general excise tax rate if payments are actually or constructively received prior to January 1, 2007. However, the gross proceeds from the same transactions will be subject to the 4.5% general excise tax rate if the payments are actually or constructively on or after January 1, 2007.

Under the accrual basis accounting method, gross proceeds from transactions occurring prior to January 1, 2007 will be subject to the 4.0% general excise tax rate if the right to receive such income is fixed under the all events test prior to January 1, 2007, but will be subject to the

4.5% general excise tax rate if the right to receive such income is fixed on or after January 1, 2007. Therefore, gross income derived from transactions reported beginning in January 1, 2007 could be subject to the 4.5% general excise tax rate even though the income is derived from transactions occurring prior to January 1, 2007.

The accounting method principle governs when gross income will be taxable. Accordingly, any income taken into account under the taxpayer's method of accounting after January 1, 2007 will be subject to the 4.5% general excise tax rate.

For more information on this Tax Information Release, please contact the Rules Office at (808) 587-1577.

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