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DEPARTMENT OF TAXATION ANNOUNCEMENT NO. 2013-04

RE: Sunset of Act 105, Session Laws of Hawaii 2011, Relating to Taxation

On June 9, 2011, Governor Neil Abercrombie signed into law Senate Bill 754, SD1, HD1, CD1 as Act 105, Session Laws of Hawaii 2011 (Act 105). Act 105 suspends numerous General Excise Tax (GE Tax) and Use Tax exemptions, exclusions and deductions, and also requires information reporting on all GE and Use Tax exclusions, exemptions and deductions. Act 105 repeals on June 30, 2013, after which all GE and Use Tax exclusions, exemptions and deductions under it will no longer be suspended.

Summary of Act 105

Act 105 suspends temporarily the exemptions for certain persons and certain amounts of gross income or proceeds from the GE and Use tax and requires the payment of both taxes at a four per cent rate. The persons and amounts for which the exemption under the GE Tax has been suspended are as follows[1]:

1. Amounts deducted from the gross income received by contractors as described under section 237-13(3)(B);
2. Reimbursements received by federal cost-plus contractors for the costs of purchased materials, plant, and equipment as described under section 237-13(3)(C);
3. Amounts deducted from the gross income of real property lessees because of receipt from sublessees as described under section 237-16.5;
4. The value or gross income received by nonprofit organizations from certain conventions, conferences, trade show exhibits, or display spaces as described under section 237-16.8;
5. Amounts received by sugarcane producers as described under section 237-24(14);

[1] Note that Act 105 lists "Gross receipts of home service providers acting as service carriers providing mobile telecommunications services to other home service providers as described under section 237-13(6)(D)" as one of the exemptions temporarily suspended. However, these amounts are exempt under federal law and thus remain exempt during the suspension period regardless of their inclusion in Act 105. Please see Tax Information Release 2011-03 for more information.

6. Amounts received from the loading, transportation, and unloading of agricultural commodities shipped interisland as described under 237-24.3(1);
7. Amounts received from the sale of intoxicating liquor, cigarettes and tobacco products, and agricultural, meat or fish products to persons or common carriers engaged in interstate or foreign commerce as described under section 237-24.3(2);
8. Amounts received or accrued from the loading or unloading of cargo as described under section 237-24.3(4)(A);
9. Amounts received or accrued from tugboat and towage services as described under section 237-24.3(4)(B);
10. Amounts received or accrued from the transportation of pilots or government officials and other maritime-related services as described under section 237-24.3(4)(C);
11. Amounts received by labor organizations for real property leases as described under section 237-24.3(10);
12. Amounts received as rent for aircraft or aircraft engines used for interstate air transportation as described under section 237-24.3(12);
13. Amounts received by exchanges and exchange members as described under section 237-24.5;
14. Amounts received as high technology research and development grants under section 206M-15 as described under section 237-24.7(10);
15. Amounts received from the servicing and maintenance of aircraft or construction of aircraft service and maintenance facilities as described under section 237-24.9;
16. Gross proceeds from the sale of the following:
    (A) Intoxicating liquor to the United States (including any agency or instrumentality of the United States that is wholly owned or otherwise so constituted as to be immune from the levy of a tax under chapter 238 or 244D, but not including national banks) or any organization to which the sale is permitted by the proviso of "Class 3" of section 281-31 that is located on any Army, Navy, or Air Force reservation as described under section 237-25(a)(1);
    (B) Tobacco products and cigarettes to the United States (including any agency or instrumentality thereof that is wholly owned or otherwise so constituted as to be immune from the levy of tax under chapter 238 or 245, but not including national banks) as described under section 237-25(a)(2);
    (C) "Other tangible personal property" to the United States (including any agency, instrumentality, or federal credit union thereof, but not including national banks) and any state-chartered credit union as described under section 237-25(a)(3);
17. Amounts received by petroleum product refiners from other refiners for further refining of petroleum products as described under section 237-27;
18. Gross proceeds received from the construction, reconstruction, erection, operation,

use, maintenance, or furnishing of air pollution control facilities, as described under section 237-27.5, that do not have valid certificates of exemption on July 1, 2011;

19. Gross proceeds received from shipbuilding and ship repairs as described under section 237-28.1;
20. Amounts received by telecommunications common carriers from call center operators for interstate or foreign telecommunications services as described under section 237-29.8;
21. Gross proceeds received by qualified businesses in enterprise zones, as described under section 209E-11, that do not have valid certificates of qualification from the department of business, economic development, and tourism on July 1, 2011; and
22. Gross proceeds received by contractors licensed under chapter 444 for construction within enterprise zones performed for qualified businesses within the enterprise zones or businesses approved by the department of business, economic development, and tourism to enroll into the enterprise zone program, as described under section 209E-11.

The persons and amounts for which exemption under the use tax has been suspended are as follows:

1. The leasing or renting of aircraft or keeping of aircraft solely for leasing or renting for commercial transportation of passengers and goods or the acquisition or importation of aircraft or aircraft engines by a lessee or renter engaged in interstate air transportation, as described under paragraph (6) of the definition of "use" in section 238-1;
2. The use of oceangoing vehicles for passenger or passenger and goods transportation from one point to another within the State as a public utility, as described under paragraph (7) of the definition of "use" in section 238-1;
3. The use of material, parts, or tools imported or purchased by a person licensed under chapter 237 that are used for aircraft service and maintenance or the construction of an aircraft service and maintenance facility, as described under paragraph (8) of the definition of "use" in section 238-1;
4. The use or sale of intoxicating liquor and cigarette and tobacco products imported into the State and sold to any person or common carrier in interstate commerce, whether ocean-going or air, for consumption out of State by the person, crew, or passengers on the shipper's vessels or airplanes, as described under section 238-3(g);
5. The use of any vessel constructed under section 189-25 prior to July 1, 1969, as described under section 238-3(h); and
6. The use of any air pollution control facility subject to section 237-27.5 as described under section 238-3(k).

Act 105 also requires that, beginning July 2011, taxpayers provide information reporting on

any general excise or use tax exclusions or exemptions. The Act provides some exceptions to the information reporting requirement. There will be no information reporting on amounts exempt under section 237-24(1) through (7), which includes amounts received from some types of insurance policies, gifts, compensatory tort damages, employee wages, and alimony.

The Department issued Schedule GE-1, Survey of General Excise Tax Exemptions and Deductions, to meet this reporting requirement. Schedule GE-1 must be filed by any taxpayer claiming exemptions or deductions under Chapters 237 and 238 for tax years 2010, 2011 and 2012. However, nonprofit organizations which have applied for and received from the Department an exemption from the general excise tax will not be subject to this information reporting requirement and do not have to file a Schedule GE-1.

Schedule GE-1 is filed exclusively by means of electronic filing at www.ehawaii.gov/efile. For more information about filing Schedule GE-1, please see the Schedule GE-1 Instructions and Tax Announcement 2011-26, all of which can be found on the Department's website at www.hawaii.gov/tax.

Grandfathering Guidelines

The Department has received numerous inquiries about how Act 105 will apply to gross receipts received or accrued after June 30, 2013 pursuant to contracts entered into during the suspension period of July 1, 2011 through June 30, 2013. Gross receipts received or accrued on or after July 1, 2013 will be subject to all provisions suspended by Act 105, regardless of whether the contract from which the gross receipts arise was entered into prior to July 1, 2013 (a.k.a., no "grandfathering-out"). In other words, the suspension of deductions, exemptions and exclusions under Act 105 will not apply to any gross receipts received or accrued after June 30, 2013. The fact that the receipts arise from a contract entered into before July 1, 2013 will not affect whether the receipts are subject to an exemption or exclusion. The controlling factor is the date the income is received or accrued. Please see the section titled "Accounting Methods" below for more discussion of cash vs. accrual method with respect to Act 105.

The Department notes that Act 105 contains provisions stating that the suspension of the exemptions and exclusions does not apply to gross income from certain binding written contracts entered into prior to July 1, 2011. In other words, contracts can be "grandfathered in" and gross receipts arising pursuant to such contracts would remain exempt or excludable even if received after June 30, 2011. Please see Tax Announcement 2011-10 for more information about grandfathering guidelines.

Act 105 contains no similar "grandfathering out" provisions. Therefore, gross receipts received or accrued on or after July 1, 2013 will be subject to all applicable exemptions and exclusions suspended under Act 105, regardless of when the taxpayer enters into the contract which gives rise to the income.

EXAMPLE. A general contractor (Contractor) enters into a contract with a developer (Developer) June 15, 2013 to build a building for $1 million. On June 20, 2013, Contractor enters into a subcontract with Subcontractor A to install the glass windows for $100,000. On June 25, 2013 Subcontractor A enters into a subcontract with Subcontractor B to install a portion of the windows for $25,000. All parties are licensed pursuant to Chapters 237 and 444, Hawaii Revised Statutes, are contractors as that term is defined under Section 237-6, and are on a cash-based accounting method. Developer pays Contractor $1 million on July 1, 2013. Contractor pays Subcontractor A $100,000 on July 2, 2013. Subcontractor A pays Subcontractor B $25,000 on July 3, 2013. Contactor may claim the subcontract deduction under section 237-13(3)(B) for payments made to Subcontractor A, even though the contract between Contractor and Subcontractor A was entered into before July 1, 2013. Subcontractor A may claim the subcontract deduction for payments made to Subcontractor B even though the contract between Subcontractors A and B was entered into before July 1, 2013.

Accounting Methods

Gross proceeds for business transactions that occur prior to July 1, 2013 could be subject to different tax rates depending on the accounting method of the taxpayer. 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.

This means that two different taxpayers entering into identical transactions could potentially pay general excise tax at two different rates. If, for instance, all events that fix the right to receive income from a contract have occurred and the amount of income can be determined with reasonable accuracy on June 30, 2013 but cash payment is actually or constructively received July 1, 2013, then a cash-basis accounting taxpayer would be exempt from GE tax on proceeds from the contract while an accrual-basis accounting taxpayer's proceeds would be subject to GE tax at the 4% rate.

Additional Information

The Department has several publications on the subject of Act 105. Below is a list of those publications and short summary of each:

1. Tax Information Release 2011-02 clarifies the application of the GE tax to sales of tangible personal property to the federal government due to Act 105, and clarifies the grandfathering rules of Act 105 for requests for proposals issued by a local, state or federal government.
2. Tax Information Release 2011-03 clarifies that gross receipts of Hawaii mobile telecommunications service providers acting as serving carriers providing interstate

or foreign mobile telecommunications services to non-Hawaii home service providers are exempt from GE tax under federal law and are not affected by Act 105's suspension of section 237-13(6)(D).

3. Tax Announcement 2011-09 discusses Act 105 in general, and also discusses applicable rate, grandfathering rules, accounting method issues, and enterprise zone issues in more detail.
4. Tax Announcement 2011-10 discusses Act 105's grandfathering rules in more detail and creates additional guidance with respect to government contracts.
5. Tax Announcement 2011-22 clarifies that income exempt prior to the enactment of Act 105 is subject to the GE tax at a rate of four per cent, and is not subject to Oahu's 0.5 per cent country surcharge.
6. Tax Announcement 2011-26 discusses Act 105's information reporting requirements, specifically who must file, how to file and what information must be reported.
7. Tax Announcement 2011-27 clarifies that division of income under section 237-18 is not an exemption or deduction and therefore a person who splits income under section 237-18 is not subject to Act 105's information reporting requirements.
8. Letter Ruling No. 2012-08 discusses whether a government contract qualifies for Act 105's grandfathering exception.
9. Letter Ruling No. 2013-02 discusses whether a taxpayer's contract qualifies for Act 105's grandfathering exception.

For more information related to this Announcement, please contact the Department of Taxation's Rules Office at 808-587-1577.

/s/

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