NEIL ABERCROMBIE
GOVERNOR

SHAN TSUTSUI
LT. GOVERNOR

FREDERICK D. PABLO
DIRECTOR OF TAXATION

JOSHUA WISCH
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1540
FAX NO: (808) 587-1560

To: The Honorable David Y. Ige, Chair
and Members of the Senate Committee on Ways and Means

Date: Thursday, April 4, 2013
Time: 9:00 a.m.
Place: Conference Room 211, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: S.C.R. No. 170 Requesting the Director of Taxation to Review Section 237-25(c), Hawaii Revised Statutes, to Determine if There is a Rational Basis for the Apparent Disparity Between the Application of that Provision and Other Sections of Chapter 237, Hawaii Revised Statutes.

The Department of Taxation (Department) **opposes** S.C.R. 170, and offers the following comments for the Committee's consideration.

S.C.R. 170 requests the Department determine whether there is a rational basis for the "apparent disparity" between section 237-25(c), Hawaii Revised Statutes (HRS), and other sections of the Hawaii State Tax Law, including sections 237-14 (allowing taxpayers to pay different tax rates as may be applicable to different transactions), 237-14.5 (allowing taxpayers to segregate telecommunications business income), 237-18 (allowing tourism related service providers and tour packagers to divide and apportion income amongst themselves and also allowing travel agents and tour packagers to divide and apportion income between themselves and transient accommodations operators), 237-21 (allowing taxpayers to apportion multistate income to Hawaii and other states), 237-23(a)(7) (exempting from tax persons who provide potable water to residential communities that lack access to public utility water) and 237-23(b)(3) (exempting from tax certain income covered by Internal Revenue Code section 501).

The Department respectfully opposes this measure. The rationale behind the basis for section 237-25(c), as is true for any tax benefit offered by the State, is ultimately a matter of legislative prerogative. The exemptions and allowances for apportionment in the sections named by this resolution are granted because the Legislature exercised its authority to create a tax benefit for certain transactions and not for others. The Department role is to merely administer these tax provisions in a consistent, fair and uniform manner.

If the Legislature would like to determine whether the Legislature had a rational basis for the enactment of this subsection when the original provision was adopted, the Department believes this issue may be best studied by the Tax Review Commission.

The Department offers the following discussion of section 237-25(c) and the General Excise Tax in general, for the Committee's consideration.

The General Excise Tax (GET) is imposed, under section 237-13, on "persons on account of their business or other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross income." The tax "applies at all levels of economic activity … and to virtually all goods and services." In re Tax Appeal of Cent. Union Church, 63 Haw. 199, 202 (1981).

A person's income is exempt from tax only where the Legislature has specifically granted an exemption, such as the exemptions under section 237-23(a)(7) or 237-23(b)(3) as mentioned in this resolution. Further, where not exempt, a person's business products, proceeds, and income are taxed in the manner prescribed by the Legislature. In determining the manner of taxation, one must first determine what type of product, proceed or income the taxpayer has. For instance, a taxpayer may have income from sales of tangible personal property under section 237-13(2), sales of services under section 237-13(6), or sales of a tourism-related service as part of a tour package under sections 237-13(6) and 237-18. Further, a taxpayer's income may be sourced to Oahu, Maui, another State, or another country entirely.

When making any of these determinations – whether the income is exempt, what type of income it is, or where the income is sourced – an examination of the specific transaction which gave rise to the income in question must be done. For example, a transaction could be as simple as a sale of tangible personal property for cash (e.g., selling a bicycle for $100 on Maui). Assuming the $100 constitutes business income and is not merely a casual sale, we look to the transaction to determine whether the income is exempt (likely not, as there is no exemption for sales of bicycles), what type of income it is (it is a sale of tangible personal property) and where the income is sourced (the income is sourced to Maui).

However, sometimes these determinations are not as simple. For example, if a company enters into a contract with a customer to provide it, for $1,000, with a mainframe computer and also to provide it with maintenance, repair and upkeep for that computer, the determination must be made as to whether the contract is for sale of services or tangible personal property. While the transaction is likely to be deemed a service transaction, it also involves, in some part, the provision of tangible personal property in the form of the computer itself. The fact that the transaction contains both the provision of services and the provision of tangible personal property does not make it two separate transactions. It is still a single transaction giving rise to income subject to the general excise tax. Therefore, all of the $1,000 of income from the contract is service income and would be subject to tax under section 237-13(6). The taxpayer would not be able to construe the transaction as two separate transactions: e.g., one for the sale of a computer for $500 and one for the sale of upkeep services for $500.

This distinction is important in the context of §237-25 because this section provides a GET exemption for sales of tangible personal property to the United States, but does not provide such an exemption for sales of services. In the computer example, the taxpayer may be tempted to try to construe what is truly a solitary service transaction as two separate transactions in an effort to avoid paying GET on part of its income.

An examination of the legislative history behind the enactment of section 237-25(c) shows that it was brought to the Legislature's attention that just such a problem was occurring. Taxpayers entering into service contracts with the United States were improperly construing what were solitary service transactions as two separate transactions for services and tangible personal property and claiming the exemption under section 237-25(a). The Legislature enacted to section 237-25(c) to clarify that merely because a service contract happens to involve some provision of tangible personal property as part of the overall provision of the service, it is improper to segregate the tangible personal property from the contract and construe its provision as a separate transaction.

In fact, allowing such a segregation of income could seriously erode the tax base. In the computer example, from the customer's perspective it does not matter whether the computer costs $500 and the services cost $500, or whether the computer costs $900 and the services cost $100. The customer only cares that its contract costs $1,000. If the taxpayer were allowed to segregate the value of the computer from the total value of the contract, the taxpayer would be incentivized to improperly inflate the value of the tangible personal property portion of the contract to maximize the exemption.

These examples illustrate some of the policies which the current statutory provisions address. If the Legislature desires to change the State's tax policy and its application, particularly with respect to the basis upon which tax benefits are granted, the Department is able to provide technical and administrative assistance.

Thank you for the opportunity to provide comments.