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To: The Honorable Sylvia Luke, Chair  
and Members of the House Committee on Finance

Date: Wednesday, February 6, 2019

Time: 2:00 P.M.

Place: Conference Room 308, State Capitol

From: Linda Chu Takayama, Director  
Department of Taxation

Re: H.B. 1044, Relating to Market-Based Sourcing

The Department of Taxation (Department) strongly supports H.B. 1044, an Administration measure, and offers the following comments for the Committee's consideration.

H.B. 1044 amends the sales factor by adopting market-based sourcing for sales of services and intangibles. The measure is effective upon approval and applies to taxable years beginning after December 31, 2018.

H.B. 1044 amends the way Hawaii taxes multistate businesses under the income tax. Multistate businesses are taxed in Hawaii under the Uniform Division of Income for Tax Purposes Act (UDITPA). UDITPA taxes multistate businesses by apportioning a share of their total income to each state in which they do business. The apportionment is calculated using a formula consisting of the average of the taxpayer's sales factor, property factor, and payroll factor. Historically, for purposes of the sales factor, sales of tangible personal property have been sourced using market-based sourcing whereas sales of services and intangibles have been sourced using the place of performance of services or production of intangibles.

As explained in detail below, the Department believes it is appropriate to transition to market-based sourcing for sales of services and intangibles.

First, the Department notes that UDITPA, and the sourcing rules for services and intangibles, were first formulated in the 1960s. Since that time, products that were traditionally delivered as tangible personal property are becoming consumable in intangible form and services that were previously performable only locally are now performed remotely. As this has happened, the tax base has become distorted as the sourcing rules no longer reflect the nature of the economy. For this reason, the Department thinks it is appropriate to update the sales factor to better reflect the modern economy.

Second, transitioning to market-based sourcing for the sales of services and intangibles will enhance the sales factor. The purpose of the sales factor is to take account of where the taxpayer's sales are taking place, the taxpayer's market. In contrast, the property and payroll factors measure the taxpayer's activities, specifically, its capital and labor. The sourcing of sales of services and intangibles to the place of performance is duplicative of the property and payroll factors and is not effective in measuring the taxpayer's market. Transitioning to market-based sourcing for all sales will enhance the sales factor as a measure of a taxpayer's market.

Third, the transition to market sourcing for all sales will match the sourcing law and rules applicable under Hawaii's general excise tax (GET). This will make the GET and income tax less burdensome for taxpayers to comply with and less complicated for the Department to administer.

Thank you for the opportunity to provide testimony in support of this measure.

# TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Adopt Market-Based Sourcing for UDITPA Sales Factor

BILL NUMBER: HB 1044; SB 1270 (Identical)

INTRODUCED BY: HB by SAIKI by request; SB by KOUCHI by request

EXECUTIVE SUMMARY: Changes the way the sales factor is calculated for purposes of multistate tax apportionment. The change makes the sales factor more consistent with the sourcing rules for general excise tax, but it makes application of the law less uniform among the states.

SYNOPSIS: Amends section 235-37, HRS, to specify that sales of intangible property are sourced to Hawaii to the extent the intangible property is used in Hawaii, and that sales of services are sourced to Hawaii to the extent the service is used or consumed in Hawaii.

EFFECTIVE DATE: Taxable years beginning after December 31, 2018.

STAFF COMMENTS: This is an Administration bill sponsored by the Department of Taxation and designated TAX-04 (19).

Many businesses have income from and operations in more than one state. States are permitted to tax these businesses if they have nexus with the taxing state, and the question then becomes how much income each state may tax.

For income tax purposes, most states including Hawaii have adopted the Uniform Division of Income for Tax Purposes Act (UDITPA). Under UDITPA as it exists today, a taxpayer is required to compute a property factor, which is a fraction representing the amount of property in Hawaii versus elsewhere; a payroll factor, which is a fraction measuring Hawaii payroll; and a sales factor, a fraction which measures Hawaii sales. The amount of net income apportioned to Hawaii is then the net income from operations everywhere multiplied by the average of the property, payroll, and sales factors. This three-factor formula once had nearly universal application in the states that had an income tax.

Under current law, sales other than sales of tangible personal property are in this State if the income-producing activity is performed in this State, or, if the income-producing activity is performed in more than one place, a greater proportion of the income-producing activity is performed in this State, based on cost of performance.

The bill proposes to make these rules consistent with the market-based sourcing rules contained in the general excise tax. However, a Uniform Law loses its utility when the states enacting it tinker with the way the law operates. The point of UDITPA is to determine how much of a taxpayer's business activity is taxable by Hawaii. To do so, a taxpayer needs to compare apples to apples in each State. If taxpayers are required to compute apples in Alaska and oranges in Hawaii, the basis on which the numbers can be compared loses some legitimacy.

Re: SB 712  
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