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March 4, 2010

LETTER RULING NO. 2010-04

[redacted text]

[redacted text]

Re: Application of the general excise tax on the sale of tangible personal property by an out-of-state seller

Dear [redacted text]:

The following legend shall apply to this letter:

Company A = [redacted text]

Company B = [redacted text]

Company C = [redacted text]

State X = [redacted text]

This responds to your letter of February 24, 2009 as supplemented by your cover letter of May 14, 2009 and transmission of Form A-7 (collectively referred to as "your letter") requesting a ruling from the State of Hawaii Department of Taxation (the "Department") on the issues listed below. The issues are:

1. Is the sale of automated pill counters, photo minilabs, printer cartridge refill machines and balers by Company B to Company C considered manufacturing equipment subject to the general excise tax ("GET") rate of 0.5% under Hawaii Revised Statutes ("HRS") §237-13(1)(A)?
2. Is Company B a wholesaler under HRS §237-16(A) and/or a wholesaler/intermediary service provider under HRS §237-13(6)(A)?
3. Are interstate transactions where both the title of goods passes outside of Hawaii, and the goods are initially shipped to a wholesaler located outside of Hawaii exempt from GET under the Commerce Clause of the U.S. Constitution?

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SHORT ANSWER

1. No, the sale is not a manufacturing activity subject to the GET rate of 0.5%. The sale of equipment by Company B to Company C is a retail sale of tangible personal property (“TPP”) subject to the GET rate of 4%¹ under HRS §237-13(2)(A).
2. No, Company B is not a wholesaler or intermediary service provider for the situations described in this letter. Company B is a retailer of TPP.
3. Where the passing of title occurs is irrelevant for GET purposes because GET is not imposed when title passes. Rather, GET is imposed when business is transacted in Hawaii. The sale of TPP which originates outside of Hawaii is not subject to GET unless (1) the place of delivery is in Hawaii and (2) the seller has nexus. If one of these elements is missing, GET will not be imposed.

FACTS REPRESENTED BY COMPANIES A, B, and C

Company A, a retail chain of consumable products, is incorporated and headquartered in State X. Company A has retail stores throughout the United States, the District of Columbia, and Puerto Rico, including retail stores in Hawaii through its wholly-owned subsidiary, Company C. Company C has no locations outside of Hawaii.

Company B, a procurement company designed to supply goods to Company A and its subsidiaries, is incorporated and headquartered in State X. Company B procures equipment, office supplies, and other non-inventory products required by Company A and its subsidiaries, including Company C. Company B does not procure any inventory that will be resold as merchandise in the stores of Company A or its subsidiaries. Company B has an administrative services agreement with Company A, which obligates Company A to provide Company B with administrative support in exchange for a fee. Company B performs all sales-related activities and document-processing functions at its office in State X. Company B, a wholly-owned subsidiary of Company A, is a separate legal entity with its own Federal Employer Identification Number (“FEIN”) and Hawaii general excise tax license. Company B has no physical presence in Hawaii and no other locations outside of State X.

Description of Equipment

Company B sells automated pill counters, photo minilabs, printer cartridge refill machines and balers to Company C. Your letter provided the following descriptions:

Automated pill counters: Machines that provide the functions of processing the counting of pills and validation counting, weighing (include scales), bottling/packaging/preparing for sale.

¹ 4.5% if attributable to the City & County of Honolulu.

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Photo minilabs: A machine composed of an operating center (computer, monitor, scanner, etc.) for processing photo layouts, a print engine, and image processing software. Converts film and digital images onto photographic paper.

Printer cartridge refill machines: These machines refill computer printer ink cartridges. Refill process is a multi-step function; (1) electrical test checks for defective cartridges prior to start of refill process, (2) a processor system consisting of fill cradles processes new ink by first cleaning the print head and evacuating any existing ink, and then refilling the cartridge with new ink; and finally (3) prepares the refilled cartridge for sale by implementing a quality control process by publishing a test pattern printed on a test page.

Balers: Balers are waste disposal/recycling machines used to compress discarded waste such as cardboard packaging and paper into bales bound with baling wire. The end result is a bundle that is resold to recyclers.

The Sales Process

Company C determines its needs and conveys this information to Company B. Company B purchases TPP (e.g., equipment, office supplies, and other non-inventory products) from a third-party vendor for resale to Company C for Company C's use in one of three scenarios as described below. The vendor bills Company B and Company B bills Company C. Company C pays Company B and Company B pays the vendor. The pricing on the TPP sold by Company B to Company C reflect arm's length pricing and includes GET. The three scenarios are:

- (1) Company B purchases TPP from a third-party vendor located in Hawaii and the vendor ships the TPP directly to Company C.
- (2) Company B purchases TPP from a third-party vendor located outside of Hawaii and the vendor ships the TPP directly to Company C.
- (3) Company B purchases TPP from a third-party vendor located outside of Hawaii, the vendor ships the TPP to a Company B warehouse outside of Hawaii, then Company B ships it to Company C.

LAW & ANALYSIS

General Information

Hawaii levies a business privilege tax against every person engaging in business within the State called the GET. The tax is measured by the application of rates against values of the products, gross proceeds of sale or gross income received from doing business in the State. Generally, the tax rate is 0.5% if the income is from a business activity such as wholesaling, producing, or manufacturing. Most other income from activities such as retailing, leasing, and

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contracting, are taxed at 4%¹. As distinguished from a sales tax, the legal incidence of the GET is upon the seller and not on the purchaser. The seller may visibly pass on the GET to the purchaser, but it is not a statutory requirement, rather it is a matter of contract between the seller and purchaser. The seller's GET liability is computed on its gross receipts, which includes the amount of any GET passed on to the purchaser.

As a complement to the GET, the Use Tax is imposed on the importer of TPP and/or services based on the landed value of TPP and/or services imported from an unlicensed out-of-state seller for further use or resale in Hawaii. The landed value of imported TPP is the fair and reasonable cash value of the property when it arrives in Hawaii. It includes the sales price, shipping and handling fees, insurance costs, custom duties, etc. It does not include sales tax paid in another state. HRS §238-1 defines an “unlicensed seller” as “any seller who, with respect to the particular sale, is not subject to the tax imposed by chapter 237, whether or not the seller holds a license under that chapter, but does not include any seller with respect to any sale which is expressly exempted from the tax imposed by chapter 237.” The tax rate is 0.5% if the TPP and/or services is intended for resale at retail; 4%¹ if the TPP and/or services is intended for use by the importer or purchaser; or no Use Tax if the TPP and/or services is intended for resale at wholesale.

HRS §237-8.6 provides for a county surcharge (“CS”) thereby increasing the GET/Use Tax rate of 4% by 0.5% for a total tax rate of 4.5%. The CS is imposed on activities that are subject to the GET/Use Tax at the rate of 4% and attributable to the City & County of Honolulu. The CS does not apply to activities such as wholesaling, producing, or manufacturing which are taxed at less than 4% for GET/Use Tax purposes or activities attributable to counties outside of the City & County of Honolulu.

Manufacturing

HRS §237-13(1)(A) defines “manufacturing” to include among other things, “compounding, canning, preserving, packing, printing, publishing, milling, processing, refining, or preparing for sale, profit, or commercial use, either directly or through the activity of others, in whole or in part, any article or articles, substance or substances, commodity or commodities...” Company B’s conclusion that the purchase of manufacturing equipment by a retailer for use in a manufacturing activity is subject to a lower GET rate based upon both HRS §237-13(1)(A) and *Re Tax Appeal of Fuji Photo Film Hawaii, Inc.*, 79 H. 503, 904 P.2d 517 (1995) is incorrect. The sale of automated pill counters, photo minilabs, printer cartridge refill machines, and balers by Company B to Company C for Company C’s use is not a manufacturing activity; it is the retail sale of TPP and subject to GET at the rate of at 4%¹ under HRS §237-13(2)(A). Company B is not engaged in a manufacturing activity. The sale of equipment is distinguished from the sale of materials used in a manufacturing activity. See the discussion of HRS §237-4(a)(2) below.

¹ 4.5% if attributable to the City & County of Honolulu.

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Wholesaling

HRS §237-4(a)(1) defines “sales at wholesale” to include among other things, “Sales to a licensed retail merchant, jobber, or other licensed seller for purposes of resale.” The sale of equipment, office supplies, and other non-inventory products by Company B to Company C is not a wholesale sale because Company C purchases the items for its own use and not for resale.

HRS §237-4(a)(2) defines “sales at wholesale” to include among other things, “Sales to a licensed manufacturer of materials or commodities that are to be incorporated by the manufacturer into a finished or saleable product (including the container or package in which the product is contained) during the course of its preservation, manufacture, or processing, including preparation for market, and that will remain in such finished or saleable product in such form as to be perceptible to the senses, which finished or saleable product is to be sold and not otherwise used by the manufacturer” [emphasis added]. Note that in *Re Tax Appeal of Fuji Photo Film Hawaii, Inc.*, 79 H. 503, 904 P.2d 517 (1995), the color print paper and chemicals were incorporated into the finished products. The automated pill counters, photo minilabs, printer cartridge refill machines, and balers are not incorporated into a finished product in a form perceptible to the senses; therefore, the sale of such equipment is not a wholesale sale.

Your letter references HRS §237-13(6)(A), pertaining to the taxation of service providers, and concludes “a seller is a wholesaler when a vendor acquires goods at the request of another vendor who is acquiring the goods for the purpose of reselling the goods” based on HRS §237-4(a)(10)(ii). HRS §237-13(6)(A) imposes GET at the rate of 0.5% on wholesale services as defined in HRS §237-4(a)(10). HRS §237-4(a)(10)(ii) provides that the sale of services to a licensed seller engaging in a business in the context of a service-to-tangible personal property transaction, qualifies as a wholesale sale if: (1) a service is rendered upon the order or request of a licensed seller for the purpose of manufacturing, producing, or preparing TPP to be sold; (2) the benefit of the service passes to the customer of the licensed seller as an identifiable element of the property being sold to the customer; (3) the cost of the service must not be overhead to the licensed seller; (4) the gross income of the licensed seller is not divided (income-splitting) between the licensed seller and another licensed seller for imposition of the GET; (5) the gross income of the licensed seller is not subject to a deduction under the GET Law; and (6) the resale of the service is subject to 4%¹ GET. These statutes are not applicable because Company B is not selling services to Company C.

Your references to HRS §237-16(A) are not applicable as it was repealed. Your references to “intermediary” were discussed in its expanded application as “wholesaling.”

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GET/Use Tax on Sales of TPP by an Out-of-State Seller

The Department has addressed the applicability of GET/Use Tax to the sale of TPP by an out-of-state seller including drop shipments in Tax Information Release No. 95-5. The GET/Use Tax as it applies to the three scenarios presented in your letter is explained below.

- (1) Company B purchases TPP from a third-party vendor located in Hawaii and the vendor ships the TPP directly to Company C. The vendor has nexus in Hawaii and is subject to 0.5% GET on its wholesale sale to Company B and Company B is subject to 4%¹ GET on its retail sale to Company C.
- (2) Company B purchases TPP from a third-party vendor located outside of Hawaii and the vendor ships the TPP directly to Company C. If the vendor has nexus in Hawaii, it is subject to 0.5% GET on its wholesale sale to Company B. If the vendor does not have nexus, then Company B is considered to have imported TPP from an unlicensed seller and is subject to 0.5% Use Tax on the landed value of the TPP, and subject to 4%¹ GET on its retail sale to Company C.
- (3) Company B purchases TPP from a third-party vendor located outside of Hawaii, the vendor ships the TPP to a Company B warehouse outside of Hawaii, then Company B ships it to Company C. Company B is considered to have imported TPP from an unlicensed seller and is subject to 0.5% Use Tax on the landed value of the TPP, and subject to 4%¹ GET on its retail sale to Company C. The vendor is not subject to GET on its sale to Company B because the place of delivery is outside of Hawaii. The vendor is considered to be an “unlicensed seller” in this particular transaction whether or not the vendor holds a license because it is not subject to GET.

Interstate Transactions

The imposition of GET/Use Tax does not violate the Commerce Clause. States are afforded the right to tax sales occurring within their jurisdiction by the U.S. Constitution. Once a business establishes nexus in Hawaii, it is subject to Hawaii taxes. While physical presence is one factor that may establish nexus, it is not the only factor; therefore, all the facts must be evaluated in order to determine whether a business has nexus or not. The assumption is that Company B has nexus in Hawaii. If Company B did not have nexus, then Company C would be subject to 4%¹ Use Tax on its purchases from Company B under HRS §238-2.

CONCLUSION

Companies B and C have nexus in Hawaii. The sale of automated pill counters, photo minilabs, printer cartridge refill machines, balers, equipment, office supplies, and other non-inventory products by Company B to Company C for Company C’s use is the retail sale of TPP and subject to 4%¹ GET under HRS §237-13(2)(A). The sale does not qualify as a

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manufacturing, wholesaling, intermediary service, or service activity. Hawaii imposes GET/Use Tax on all transactions occurring within its jurisdiction. For interstate transactions that involve the sale of TPP, the imposition of GET/Use Tax depends upon whether or not the parties are licensed sellers with nexus in Hawaii and where the TPP is delivered.

This ruling only applies to Companies A, B, and C and is based upon our understanding of the facts that Companies A, B, and C have represented. It may not be used or cited as precedent by any other taxpayer. If it is later determined that our understanding of these facts is not correct, the facts are incomplete, or the facts later change in any material respect, this ruling will be void. This ruling may also be subject to change without notice due to future amendments to laws, rules, or official Department positions. If you have any further questions regarding this matter, please direct your correspondence to my attention or call me at (808) 587-1577.

Sincerely,

/s/ Adriane Aarona

ADRIANE AARONA
Income Tax Specialist