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March 23, 2012

LETTER RULING 2012-06

[Redacted Text]
[Redacted Text]
[Redacted Text]
[Redacted Text]

Re: Taxability of Certain Software Sales Made By **[Redacted Text]**

Dear **[Redacted Text]:**

This responds to your request of June 25, 2010, as supplemented by the emails of February 15, 2011, of **[Redacted Text]** (the "Company"), through your duly authorized representative, **[Redacted Text]**, requesting a ruling from the State of Hawai`i Department of Taxation (the "Department") on whether the Hawai`i General Excise ("GE") tax must be paid on the sale of certain software developed by the Company and licensed and/or sold to a related company, which consumes the product/services out of this state.

SHORT ANSWER

Based on the information in your letter request for a ruling, as supplemented by the emails of February 15, 2011, the gross proceeds derived from software developed by the Company and licensed and/or sold to **[Redacted Text]** (a related company), which utilizes the software entirely out of this state, is not subject to the GE tax.

FACTS REPRESENTED BY THE COMPANY

The Company is a limited liability company which is engaged in the business of **[Redacted Text]**. The Company is an entity disregarded for income taxes and is wholly owned by **[Redacted Text]**, which in turn is owned by **[Redacted Text]** and other non-related entities. Their primary activity is the research and development of **[Redacted Text]**. The Company created this customized software for license and/or sale to **[Redacted Text]**, which utilizes the software out of the state. **[Redacted Text]** has no customers in Hawai`i.

LAW AND ANALYSIS

In Tax Information Release 97-4, the Department applied the IRC Section 7701 elections with modification for the GE and similar taxes:

> **III. The IRC Section 7701 Check-The-Box Regulations are Applicable to the General Excise Tax Law (Chapter 237, HRS), and Other Gross Receipts and Transaction-Type Hawaii Taxes, But With Modifications for Single-Member LLC Treatment.**
> **A. General Rule.**
>
> The entity classification elected for income tax purposes under the check-the-box regulations will control the classification of the entity for purposes of the general excise tax ("GET"), (chapter 237, HRS), transient accommodations tax, (chapter 237D, HRS), public service company tax, (chapter 239, HRS), fuel tax, (chapter 243, HRS), liquor tax, (chapter 244D, HRS), cigarette and tobacco tax, (chapter 245, HRS), conveyance tax, (chapter 247, HRS), rental motor vehicle and tour vehicle surcharge tax, (chapter 251, HRS), and nursing facility tax laws (chapter 346E, HRS). All business entities, including a single-member LLC, are taxable at the entity level for purposes of the GET and the other gross receipts and transaction-type Hawaii tax laws. *See generally, In re Island Holidays, Ltd.,* 59 Haw. 307, 582 P.2d 703 (1978). For example, if an entity is classified as a partnership for income tax purposes, the GET and other gross receipts and transaction-type taxes are imposed at the entity level. In like fashion, a single-member LLC is treated as a taxable entity for these taxes notwithstanding that the LLC is disregarded under the check-the-box regulations. Any business entity having shareholders, partners, or members remains taxable upon its business with them, and they are taxable upon their business with it. As a taxable business entity, a single-member LLC is taxable upon its business with its member, and the member is taxable upon its business with the LLC, unless specifically exempted under applicable law (e.g., HRS section 237-23.5).

Thus, while the Company is disregarded for income taxes (and is treated as an operating division of its sole member for purposes of the income tax), for GE taxes, the Company is considered separate and distinct. Hawai`i 's GE tax is a gross receipts tax on the privilege of doing business in Hawai`i, and is measured by the application of rates against value of products, gross proceeds of sales or gross income received from doing business in Hawai`i . See e.g. In re Grayco Land Escrow, 57 Haw. 436, 447, 559 P.2d 264, 272 (1977), which held that the GE tax "is based on the privilege or activity of doing business within the State and not on the fact of domicile". A privilege tax is assessed based on the fact that the party chose to engage in business activity within the state, and as such, enjoy the protections and benefits provided by the state. Wisconsin v. J.C. Penney Co., 311 U.S. 435, 444 (1940) (holding that a foreign corporation licensed to do business within the state may be subject to a privilege tax "if by the practical operation of a tax the state has exerted its power in relation to opportunities which it has given,

to protection which it has afforded, to benefits which it has conferred by the fact of being an orderly, civilized society").

Hawai`i Revised Statutes ("HRS") § 237-13(2) provides for the imposition of the GE tax on sales of tangible personal property at the rate of 0.5 percent on wholesale sales or at the rate of 4 percent on retail sales. Similarly, HRS § 237-13(6) provides for the imposition of the GE tax on the gross proceeds of service businesses at the rate of 0.5 percent on wholesale sales or at the rate of 4 percent on retail sales. HRS § 237-14 provides that the imposition of taxes and the application of tax rates do not depend upon the business in which the taxpayer is primarily engaged.

The GE tax is especially broad in scope because "in plain and unmistakable language the statute evidences the intention of the legislature to tax every form of business, subject to the taxing jurisdiction, not specifically exempted from its provisions." Grayco Land, 57 Haw. at 443, 559 P.2d at 270. However, before the GE tax can be imposed on sales made through interstate commerce, there must be a connection between the state and the economic activities of the company based outside that state. The Due Process and Commerce Clauses of the United States Constitution limits the state's jurisdiction to tax. Article I, Section 8 of the United States Constitution prohibits the states from imposing taxes on interstate commerce by explaining that only "Congress shall have power to lay and collect taxes . . . [t]o regulate Commerce . . . among the several States[.]" Likewise, nexus requirements must be satisfied before an out-of-state business may be subject to the taxing jurisdiction of a given state.

The extent of the general excise tax is also "mitigated by limited categories of exemptions from coverage provided for certain persons or entities, certain activities, and described transactions." See In re Queen's Medical Center, 66 Haw. 318 (1983) (citing In re Tax Appeal of Central Union Church, 63 Haw. 199, 202-03 (1981)).

HRS § 237-29.5 provides:

> §237-29.5 Exemption for sales of tangible personal property shipped out of the State. (a) There shall be exempted from, and excluded from the measure of, the taxes imposed by this chapter all of the value or gross proceeds arising from the manufacture, production, or sale of tangible personal property:
>
> (1) Shipped by the manufacturer, producer, or seller to a point outside the State where the property is resold or otherwise consumed or used outside the State; or
>
> (2) The sale of which is exempt under section 237-24.3(2).

Likewise, HRS § 237-29.53 provides:

> §237-29.53 Exemption for contracting or services exported out of State. (a) There shall be exempted from, and excluded from the measure of, taxes imposed by this chapter, all of the value or gross income derived from contracting (as defined under section 237-6) or

services performed by a person engaged in a service business or calling in the State for use outside the State where:

(1) The contracting or services are for resale, consumption, or use outside the State; and

(2) The value or gross income derived from the contracting or services performed would otherwise be subject to the tax imposed under this chapter on contracting or services at the highest rate.

Where statutes simply overlap in their application, effect will be given to both if possible, because repeal by implication is disfavored. See Metcalf v. Voluntary Employees' Benefit Assn. of Hawai`i, 99 Haw. 53 (2002); Richardson v. City & County of Honolulu, 76 Haw. 247 (1994). "A rational, sensible and practicable interpretation of a statute is preferred to one which is unreasonable or impracticable; the Legislature is presumed not to intend an absurd result, and legislation will be construed to avoid, if possible, inconsistency, contradiction, and illogicality." Metcalf, 99 Haw. at 59-60 (citation omitted).

Historically, a transaction could be clearly identified as the sale of a service, the sale of tangible personal property or some combination of both. A few years ago, electronically downloaded software and other media such as music and movies was virtually unheard of. Software, music, movies, etc traditionally had always been delivered on a tangible medium such as a CD, DVD or magnetic tape, and there was no doubt that it was a tangible product and taxed as such. Technological innovations and the rapid advances being made have now blurred the lines between product and service. Software as a Service ("SAAS") and electronically delivered content perplex both taxing authorities and sellers on the correct tax treatment to be accorded it, with no uniform consensus. Also known as on-demand hosting or subscription-based software, SAAS has grown exponentially and generally enables customers to pay for the use of Web-based software instead of purchasing or licensing the software outright. The software and other digital media application delivery model has also grown exponentially in the past few years, since one no longer needs to wait for the delivery of a physical disk before being able to use it. Not surprisingly, sellers, buyers, legal counsel and tax auditors are arriving at different conclusions on how a transaction should be taxed, depending on how they answer questions such as:

- Should SAAS be treated like electronically delivered software?
- Is a license agreement imperative, and what happens if there is none?
- Is SAAS simply a “license to use”?
- Is SAAS an information service or database?
- What if tangible backup copies are provided to the licensee?
- What if the agreements provide for periodic updates?
- Is a sale sourced to the customer’s billing/shipping address?
- Is a sale sourced to where the hosting server is located, because the software is “used” in that state?
- Is a sale sourced to where users access it?
- What if it's not known where the users are?

It should be noted that a bill has been introduced in Congress, which may provide uniform guidance. The Digital Goods and Services Tax Fairness Act of 2010 (H.R. 5649) was introduced on June 30, 2010, to promote "neutrality, simplicity and fairness in the taxation of digital goods and digital services." One of the most significant portions of the bill proposes sourcing the sale of digital goods (including software) to a single location for sales tax and use tax purposes.

Regardless of whether the software is a product, a service, or some combination of the two, the Company has represented that it is consumed entirely outside the state, and that the Company has no Hawai`i customers. As such, the transaction is exempted under HRS § 237-29.5 and/or HRS § 237-29.53, and no GE tax must be paid.

CONCLUSION

Based solely on the information and representations submitted, the gross proceeds received by the Company for software it developed and has licensed and/or sold to **[Redacted Text]** (a related company), and which is utilized entirely out of this state, is not subject to the GE tax. **The Department makes no determination as to the proper income tax treatment of such sales.**

This ruling is applicable only to the Company, and shall not be applied retroactively. It may not be used or cited as precedent by any other taxpayer, and is limited to the facts as represented based upon our understanding of the facts. No representation is made as to any other transaction, regardless of the similarities of fact. 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, the conclusion in this letter will be modified accordingly. This ruling also may be subject to change due to future amendments to laws, rules, or official Department positions.

If you have any further questions regarding this matter, please email me at mark.j.yee@Hawaii.gov. Additional information on Hawai`i 's taxes is available at the Department's website at **www.state.hi.us/tax**.

Very truly yours,

MARK J.C. YEE
Administrative Rules Specialist