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TAX INFORMATION RELEASE 2001-4

RE: The Definition of "Cost"; The Payment of Tax Requirement; and Safe Harbor Guidelines Pertaining to the Capital Goods Excise Tax Credit

This Tax Information Release ("TIR") discusses the requirements for claiming the refundable capital goods excise tax credit ("Credit") provided by §235-110.7, Hawaii Revised Statutes ("HRS"). Specifically, the TIR discusses in detail §235-110.7(e), HRS, which requires that the purchase or import of property eligible for the Credit must have been subject to the imposition and payment of either the general excise tax ("GET") or use tax at the four percent (4%) tax rate. This TIR:

1. Gives a general overview of the Credit's provisions;
2. Explains the term "cost" for purposes of the Credit;
3. Describes the "payment of tax requirement";
4 Prescribes new safe harbor guidelines that the Department of Taxation ("Department") will be implementing, effective as of the date of this TIR;[1] and
5. Explains the operation of the Credit provisions in conjunction with a claim for the use tax credit under §238-3(I), HRS, for taxes paid to another state.

Taxpayers may also consult §§18-235-110.7-01 to 18-235-110.7-22, Hawaii Administrative Rules ("HAR"); and TIR Nos. 88-6, 88-8, and 89-4 for more information on other aspects of the Credit.[2]

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[1] If these safe harbor guidelines are found to be ineffective without the formal promulgation of administrative rules, then the safe harbor guidelines will constitute due diligence steps that will be accepted by the Department as a reasonable basis for the taxpayer to presume that the required tax has been paid.

[2] TIR 88-6 explains the general provisions of the Credit; TIR 88-8 discusses the Credit's recapture provisions; and TIR 89-4 covers the availability of the Credit in the context of lease and sale-leaseback transactions.

I. In General

The Credit became effective on January 1, 1988, and is allowed to each taxpayer subject to the Hawaii net income tax, chapter 235, HRS, if the following requirements are met:

(1) The taxpayer purchases or imports "section 38 property," "new section 38 property," or "used section 38 property" as those terms are defined in §§18-235-110-7-04 through 18-235-110-7-06, HAR and section V of TIR No. 88-6. Hereinafter, these terms shall be collectively referred to as "eligible property";

(2) The purchase or import of eligible property results in a transaction that <u>was subject to the imposition and payment</u> of tax at the rate of four percent under either chapter 237 or chapter 238, HRS, (GET or use tax, respectively);

(3) The eligible property is used by the taxpayer in a trade or business;

(4) The eligible property is placed in service within Hawaii after December 31, 1987; and

(5) The taxpayer files a claim for the Credit on or before the end of the twelfth month following the close of the taxable year for which the Credit may be claimed.

The Credit is deductible from the taxpayer's net income tax liability for the year in which it qualifies. If the Credit exceeds the taxpayer's net income tax liability, the excess of Credit over liability shall be refunded to the taxpayer; however, no refund on account of the Credit shall be made for an amount less than $1.

A claim for the Credit, including any amended claim, must be filed on or before the end of the twelfth month following the close of the taxable year for which the Credit may be claimed. An extension of time for filing a return does not extend the time for claiming the Credit. The claim for the Credit shall be made on Form N-312. Failure to comply with these filing requirements shall constitute a waiver of the right to claim the Credit.

II. "Cost," Defined

The Credit is available for purchases of "eligible depreciable tangible personal property," which is defined as "section 38 property as defined by the operative provisions of section 48 <u>and</u> having a depreciable life under section 167 or for which a deduction may be taken under section 168 of the federal Internal Revenue Code of 1954, as amended." (Emphasis added.) The Credit is computed by multiplying the "cost" of the eligible property by four percent (4%). Section 235-110.7(e), HRS, defines "cost" as:

(1) the actual invoice price of the tangible personal property; or

(2) the basis from which depreciation is taken under section 167 (with respect to depreciation) or from which a deduction may be taken under section 168 (with respect to accelerated cost recovery system) of the Internal Revenue Code of 1954, as amended, whichever is less. (Emphasis added.)

The costs attributable to services, therefore, cannot be claimed for two reasons: 1) services do not constitute tangible personal property; and 2) the actual invoice price of the eligible property will be the "cost" used to calculate the Credit because it is less than the basis from which depreciation is taken (which includes both the cost of the eligible property and the ancillary services).

Example 1: Taxpayer purchases eligible property for $104,000 from a GET-licensed vendor. In a separate transaction, Taxpayer hires a service provider to install the property in Hawaii for $80,000. The installation is capitalized and includible in the basis of the property for depreciation. The vendor's invoice separately states the $100,000 sales price and $4,000 of GET passed-on to Taxpayer. Taxpayer may claim the Credit for the purchase of the eligible property ($104,000). However, Taxpayer may not claim a Credit for the cost of installation ($80,000). The Credit is allowed for the cost of eligible property, but not for the cost of services.

III. Payment of GET or Use Tax A Condition Precedent to Claiming the Credit

A. Statutory Basis

The term "tangible personal property" is defined in §235-110.7(e), HRS, as:

(1) Tangible personal property;
(2) Placed in service in Hawaii after December 31, 1987;
(3) The purchase or importation of which resulted in a transaction that was subject to the imposition and payment of tax at the rate of four per cent under chapter 237 or 238.

The last of these elements is interpreted by the Department to mean that either the GET or the Hawaii use tax at the rate of four percent (4%) must be timely paid by the seller or the importer/purchaser, respectively, as a condition precedent to claiming the Credit. The following examples illustrate this concept:

Example 2: In 1998, Taxpayer, operating on a calendar year basis, purchases eligible property from an out-of-state vendor who is not subject to the GET and imports the property into Hawaii. Taxpayer does not report and pay the four percent (4%) use tax on the property on Taxpayer's 1998 general excise/use tax annual return (Form G-49) filed on April 20, 1999. After December 31, 1999 (i.e., twelve months after the close of the taxable year for which the credit is claimed), Taxpayer may not claim the Credit on any amended 1998 income tax return because the Taxpayer did not report and pay the use tax on the property.

Example 3: Assume the same facts as in Example 2, except that Taxpayer has a six-month extension to file the 1998 income tax return. Taxpayer discovers that the use tax was not reported and paid on the property and files an amended general excise/use tax annual return in May 1999 to report and pay the use tax. Taxpayer may claim the Credit when Taxpayer files the 1998 income tax return in October 1999.

Example 4: Assume the same facts as in Example 2, except that Taxpayer filed the 1998 income tax return on April 20, 1999 (the original, prescribed due date). Taxpayer may claim the Credit by paying the use tax before claiming the Credit and amending the 1999 income tax return to claim the Credit by December 31, 1999.

B. Used Section 38 Property

Section 18-235-110.7-06, HAR, allows taxpayers to claim the Credit for purchases of used section 38 property when certain conditions are met. It should be noted that in cases where the sale of eligible property is a casual sale exempt from the GET under HRS §237-2, the Credit will be disallowed because no GET or Hawaii use tax has been paid. If a taxpayer is purchasing used section 38 property (such as equipment used in the seller's business), the taxpayer should obtain an invoice from the seller showing a 4% pass-on of the GET (as discussed in section IV of this TIR).

IV. Safe Harbor Guidelines

The Department recognizes taxpayers' need for safe harbor guidelines in determining whether they may safely assume that the seller has paid the GET on the sale of eligible property, and, as a result, the <u>use tax</u> need not be paid to meet the condition precedent to claiming the Credit. Because the GET is levied upon the seller, it is difficult for a taxpayer who wishes to claim the Credit to know when, in fact, the seller has paid the GET upon the gross receipts from the sale of eligible property. However, it is the taxpayer who must prove that the claim for the Credit is legitimate, including proof that the GET has been paid. For purposes of claiming the Credit only, the Department will accept the following as satisfactory evidence that the GET has been paid on the purchase of eligible property:

1. Taxpayer can provide a sales invoice or contract showing the four percent GET as a separately stated component of the purchase price;

2. Taxpayer can provide a sales invoice showing that the vendor has a Hawaii business address;

3. If the sales invoice or contract does not separately state the four percent GET, (i.e., the seller does not visibly pass-on the tax), then the taxpayer must provide the GET license number of the seller, which is valid at the time of the purchase. The taxpayer should also keep records of the seller's business name, address, and other information that the Department may use to verify that the seller was GET-licensed at the time of the purchase[3]. In the case of used property, an affidavit or statement must be obtained from the seller certifying that the transaction is not a casual sale as defined by HRS §237-1; or

4. A statement or affidavit from the seller representing that the GET has been paid.

If the taxpayer is unable to provide any of the aforementioned evidence that the GET has been paid by the seller, then the Department will presume that the GET has not been paid. As a consequence, the taxpayer should pay the use tax upon the import of the eligible property. If the use tax is not timely paid (as a condition precedent to claiming the Credit), then the Credit will be disallowed.

The safe harbor guidelines provided here are to be used only for purposes of claiming the Credit.[4] The guidelines will not absolve a taxpayer from use tax liability if it is later found (under an audit, for example) that the seller was not subject to the GET with respect to that particular transaction. In this case, the taxpayer will be liable for the use tax upon the purchase, however, the Credit will not be disallowed on the grounds that the claim was not properly made (i.e., that the "payment of tax requirement" was not met as a condition precedent to claiming the credit).

Furthermore, these guidelines shall not be utilized to determine taxability of the business of selling tangible personal property for GET purposes. If the safe harbor guidelines conflict with a later determination that taxability of the sale lies with another jurisdiction, these guidelines will not prevent the Department from assessing any appropriate taxes, nor will they prevent the taxpayer from claiming refunds for overpayment of taxes.

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[3] The taxpayer should secure the GET license number directly from the seller. Though GET license numbers are public information and can be found on the Internet at http://www.ehawaiigov.org/serv/taxpayer, business entities often register under different names from those under which they engage in business activity. Therefore, the taxpayer may risk merely obtaining the GET license number of a business with a similar name to the seller if the taxpayer relies solely on this source.

[4] These guidelines shall not be utilized to determine taxability of sales for GET purposes. If the safe harbor guidelines conflict with a later determination that taxability of the sale lies with another jurisdiction, these guidelines will not prevent the Department from assessing any appropriate taxes or the taxpayer from claiming refunds for overpayment of taxes.

Example 5: Taxpayer purchases eligible property from a vendor licensed under the GET law. The vendor's sales invoice separately states the sales price and the GET passed-on to Taxpayer. Taxpayer may claim the Credit on the income tax return because Taxpayer can show that the vendor paid the GET.

Example 6: Taxpayer purchases eligible property from a vendor licensed under the GET law. The vendor's sales invoice did <u>not</u> separately state the price and the GET passed-on to Taxpayer. Taxpayer may claim the Credit if the Taxpayer can provide the valid GET license number of the seller. If the seller is not GET-licensed, then the Taxpayer should pay the use tax and claim the Credit for use taxes paid upon the import/purchase of the eligible property.

Example 7: Taxpayer purchases eligible property from a vendor in California who happens to have a GET license number. The Taxpayer keeps in its records the name, GET license number, and address of the vendor. Upon importation of the eligible property into the State, the Taxpayer does not pay the use tax, but claims the Credit for the eligible property. Two years later, the Taxpayer is audited, and the Department discovers that although the vendor was GET-licensed, the vendor did not file a GET return for the year in question[5] because the vendor did not have the requisite contact or nexus with Hawaii with respect to this particular sale of property. The use tax, along with any applicable penalties and interest, will be assessed against the Taxpayer. However, because the Taxpayer was reasonable in assuming that the vendor would pay the GET (i.e., the vendor was GET-licensed), the original claim for the Credit will be allowed.

Example 8: Taxpayer purchases eligible property from a sales representative of an Oregon retailer. The eligible property is shipped to the Taxpayer. The sales invoice does not show a 4% tax and the Taxpayer does not inquire whether the retailer is GET-licensed, but the Taxpayer claims the Credit without paying the use tax. Two years later, the Taxpayer is selected for an audit by the Department. The Taxpayer cannot provide the GET license of the Oregon retailer and Department records do not clearly indicate that this particular Oregon retailer is licensed. The Department assesses the use tax, interest, and applicable penalties upon the import of the eligible property and the claim for the Credit is denied on the grounds that the use tax was not paid.

V. Limitation on Credit for Eligible Property for Which a Credit For Sales or Use Taxes Paid to Another State is Taken under Section 238-3(I), HRS

In the case of imported eligible property, certain limitations on the Credit apply if the full 4% use tax was not paid upon importation into Hawaii. HRS §238-3(I) provides a use tax credit

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[5] The Department might also find that the vendor filed returns, but did not report any Hawaii gross receipts or did not report enough gross receipts to suggest that the transaction was included in the filing.

for taxes paid to another state or any subdivision thereof. If the use tax credit is taken, then the amount of the capital goods excise tax credit shall not exceed the amount of use tax actually paid under chapter 238, HRS, with regard to that specific eligible property.[6]

Example 9: Taxpayer purchases eligible property for $1,030 from an unlicensed (under the GET law) out-of-state vendor and imports the property into Hawaii. The vendor's sales invoice separately states the $1,000 sales price and $30 in sales tax paid to another state (a 3% tax rate). Taxpayer reports and pays $10 use tax on the property (i.e., $40 ($1,000 x 4% use tax rate) less $30 (credit for taxes paid to another state)). Taxpayer may claim a $10 Credit (the amount of Hawaii use tax actually paid by the Taxpayer).

Example 10: Taxpayer purchases eligible property for $5,350 from an unlicensed (under the GET law) out-of-state vendor and imports the property into Hawaii. The unlicensed vendor's sales invoice separately states the $5,000 sales price and the $350 in sales tax paid to another state (7% tax rate). Taxpayer reports the importation of the property on Taxpayer's general excise/use tax return but does not pay any use tax because Taxpayer already paid a 7% tax to another state (3% more than the Hawaii 4% use tax rate). Taxpayer may not claim the Credit because Taxpayer did not pay any use tax on the property.

Forms and other tax information are available at the Department's website at: **www.state.hi.us/tax**. On Oahu, forms may be ordered by calling the Department's Forms Request Line at: 587-7572. Persons not calling from Oahu, may call: 1-800-222-7572 (toll-free) to receive forms by mail or by fax.

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HRS Section Explained: HRS §235-110.7
HAR Sections Explained: HAR §§18-235-110.7-01 to 18-235-110.7-22

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[6] HRS §235-110.7(a) states: "In the case of eligible depreciable tangible personal property for which a credit for sales or use taxes paid to another state is allowable under section 238-3(I), the amount of the tax credit allowed under this section shall not exceed the amount of use tax...actually paid under chapter 238, relating to such tangible personal property."