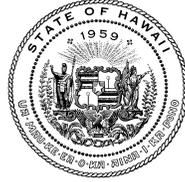


LINDA LINGLE  
GOVERNOR

JAMES R. AIONA, JR.  
LT. GOVERNOR



STATE OF HAWAII  
**DEPARTMENT OF TAXATION**  
P.O. BOX 259  
HONOLULU, HAWAII 96809  
PHONE NO: (808) 587-1510  
FAX NO: (808) 587-1560

KURT KAWAFUCHI  
DIRECTOR OF TAXATION

SANDRA YAHIRO  
DEPUTY DIRECTOR

June 15, 2009

## TAX INFORMATION RELEASE NO. 2009-02

**RE: Exemption for contracting or services exported out of state, HRS section 237-29.53; Imposition of tax on imported services or contracting, HRS section 238-2.3**

This Tax Information Release (TIR) provides guidance as to the application of the general excise tax exemption for contracting or services exported out-of-state, and the application of the use tax to contracting or services imported into Hawaii, pursuant to sections 237-29.53 and 238-2.3, Hawaii Revised Statutes (HRS), respectively. This TIR supersedes TIR No. 98-9 and TIR No. 2001-2.

### I. Historical Background

Section 237-21, HRS, the apportionment statute, requires the following:

If any person . . . is engaged in business both within and without the State . . . , and if under the Constitution or laws of the United States . . . the entire gross income of such person cannot be included in the measure of this tax, there shall be apportioned to the State and included in the measure of the tax that portion of the gross income which is derived from activities within the State, to the extent that the apportionment is required by the Constitution or laws of the United States."

HAW. REV. STAT. § 237-21 (emphasis added). Prior to the enactment of Act 98, 2002 Session Laws of Hawaii ("Act 98"), Chapter 237, HRS, did not expressly provide a credit for sales or use taxes paid to another state for a transaction as an offset against any general excise taxes that may be owing with respect to the same transaction. To comply with the provisions of section 237-21, HRS, and avoid any constitutional concerns caused by the lack of an offset for taxes paid to other states, for purposes of Chapters 237 and 238, HRS, the Department sourced and apportioned gross receipts from (or payments for) transactions based on "place of performance," as explained in TIR Nos. 98-9 and 2001-2 (see below). As stated therein, only

that portion of services actually performed in Hawaii was subjected to general excise and use taxes.<sup>1</sup>

Act 98 amended section 237-22, HRS, "Conformity to Constitution, etc.," by providing an offset for taxes paid to other states as follows:

(b) To the extent that any deduction, allocation, or other method to determine tax liability is necessary to comply with subsection (a), each taxpayer liable for the tax imposed by this chapter shall be entitled to full offset for the amount of legally imposed sales, gross receipts, or use taxes paid by the taxpayer with respect to the imported property, service, or contracting to another state and any subdivision thereof; provided that such offset shall not exceed the amount of general excise tax imposed under this chapter upon the gross proceeds of sales or gross income from the sale and subsequent sale of the imported property, service, or contracting. The amount of legally imposed sales, gross receipts, or use taxes paid by the taxpayer with respect to the import shall be first applied against any use tax, as permitted under section 238-3(i), and any remaining amount may be applied under this section for the same imported property, service, or contracting.

The director of taxation shall have the authority to implement this offset by prescribing tax forms and instructions that require tax reporting and payment by deduction, allocation, or any other method to determine tax liability to the extent necessary to comply with the foregoing.

The director of taxation may require the taxpayer to produce the necessary receipts or vouchers indicating the payment of the sales, gross receipts, or use taxes to another state or subdivision as a condition for the allowance of this offset.

HAW. REV. STAT. §237-22(b).

In summary, without a statutory provision allowing a credit or offset for taxes paid to another state, there was a risk that gross receipts would be double taxed unless gross receipts were sourced and apportioned based on "place of performance." Generally, the enactment of section 237-22(b), HRS, eliminated the prerequisite to apportion gross receipts to satisfy constitutional concerns of double taxation. Accordingly, the enactment of the above provision eliminated the need to impose a sourcing and apportionment scheme based on "place of performance" and effectively repealed the "place of performance" test. Further, upon enactment, section 237-22(b), HRS, was retroactive and expressly effective "for all open tax years and for

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<sup>1</sup> Even before Act 98 was passed, Chapter 238, HRS, which governs use taxes, already allowed a taxpayer a credit for sales or use taxes paid to another state with respect to imported property. In 1999 and 2000, the credit provision contained in Chapter 238, HRS, was expanded to provide an offset for taxes paid to another state for imported services and contracting, respectively, in addition to the credit relating to imported property. See HAW. REV. STAT. 238-3(i). The Department applied the "place of performance" sourcing and apportionment rules to Chapter 238, HRS, despite the offset provision contained in section 238-3(i), HRS, to provide internal and external consistency.

tax years that are pending appeal at the time of approval." See Act 98, 2002 SESSION LAWS OF HAWAII at 291.

## II. Sourcing Rule – "Place Used or Consumed"

In TIR No. 98-9, the Department adopted a "place of performance" test to determine whether the sale of a service was sourced to Hawaii and thus subject to general excise tax. "Place of performance" was "defined as the state or place where services are performed." TIR No. 98-9. "Performance" meant "the discharge, fulfillment, or accomplishment of a promise, contract, or other obligation according to its terms, relieving the taxpayer of all further obligation or liability thereunder." Accordingly, the examples provided in TIR No. 98-9 focused on where the taxpayer-service provider was physically located to determine whether services were provided in the State of Hawaii and subject to general excise tax. With the enactment of section 237-29.53,<sup>2</sup> HRS, the "place of performance" test as discussed in TIR No. 98-9 became obsolete.<sup>3</sup> See, e.g., TIR No. 98-9 ("The general excise tax applies to the gross income where the place of performance is wholly within the State. It does not matter that the services are performed wholly within the State but consumed outside the State ('exported services')."). The exemption provided by section 237-29.53, HRS, expressly requires that the contracting or service purchased is for "resale, consumption, or use outside the State," effectively superseding the "place of performance" test. HAW. REV. STAT. § 237-29.53.

The "used or consumed" test sources gross receipts to the place "in which the services are intended to be used or consumed." See HAW. ADMIN. RULES §18-237-8.6-03. The sourcing focus, then, shifts from where the taxpayer-service provider is physically located (as under the "place of performance" test) to the place where the customer uses or receives a benefit from the services. The Department's administrative rules regarding the county surcharge imposed by section 237-8.6, HRS, reflects the "used or consumed" test.

With respect to contracting, the purchaser uses or consumes the contracting services in the locale where the real property to which the contracting relates is situated.

In certain circumstances, where services are used or consumed both within and outside of Hawaii (i.e., the purchaser receives substantial and direct benefits traceable and identifiable to business activities both within and outside of Hawaii), only that portion of gross income from services used or consumed in Hawaii is subject to general excise tax, in accordance with section 237-21, HRS. See PROPOSED HAW. ADMIN. RULES §18-237-29.53(e), (f), and (g) Examples 7 and 10; and §18-238-2.3(e), (f) and (g) Example 5 for further guidance on the application of apportionment principles set forth in section 237-21, HRS.

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<sup>2</sup> Act 70, which enacted sections 237-29.53 and 238-2.3, HRS, was effective for taxable years beginning on or after January 1, 2000. Act 70, 1999 SESSION LAWS OF HAWAII at 106.

<sup>3</sup> Given the effective dates of Act 98, which enacted the constitutional credit provisions, and Act 70, it is the Department's position that TIR Nos. 98-9 and 2001-2 were superseded retroactively to taxable years beginning on or after January 1, 2000.

### **III. Sourcing Rule for Purposes of Chapter 238**

Section 238-2.3, HRS, requires a Hawaii importer to pay use tax on imported contracting or services, subject to the exemptions enumerated therein and elsewhere in chapter 238, HRS. Generally, whether the use tax must be paid on imported contracting or services is determined by where the services are used or consumed.

As the "place of performance test" pronounced in TIR No. 98-9 has been superseded, the application of the "used or consumed" test to section 238-2.3, HRS, renders examples provided in TIR No. 2001-2 that relied upon TIR No. 98-9 obsolete. For instance, the following examples that were provided in TIR No. 2001-2 are no longer correct for the reasons cited herein:

*Example 4. A Washington based computer software company designs and programs customized software for business clients, one of whom is located in Hawaii. The software company sends employees to Hawaii to audit the Hawaii client's business to determine the needs of the client. The employees then travel back to Washington where they complete the actual programming of the software. The software company is subject to the GET on the services it performs in Hawaii, and it may apportion the gross receipts it receives by using a separate accounting method such as the number of hours billed while in Hawaii over the number of total hours billed. The Hawaii client is also allowed to apportion the value of the services for use tax purposes, and pay the use tax at the rate of 4% on the value attributable to services performed outside of Hawaii.*

Applying the "used or consumed" test and the general framework discussed below, assuming the Washington-based computer software company has nexus to Hawaii, the Washington company must pay general excise tax on all of its gross receipts from the Hawaii client for the services provided, and the Hawaii client is not subject to use tax. If the Washington-based computer software company is required to pay a Washington gross receipts tax on the services performed, such company may claim a credit against its Hawaii general excise taxes under section 237-22, HRS. It is improper to apportion gross receipts based on time spent by the company performing services in Hawaii and in Washington as the Hawaii client uses and consumes the customized software program in Hawaii.

*Example 7. Assume the same facts as Example 6, except that the Oregon archeologist performs some of its services in Hawaii (e.g., views and inspects the site). Of the 200 hours billed to the job, 60 hours are billed for services performed within Hawaii, and the balance (140 hours) is billed for services performed in Oregon. The local contractor may apportion the value of the services and pay the use tax only upon the value of the services attributable to the services performed in Oregon (140 hours). This amount will be subject to the use tax rate of one-half of one percent (1/2%). The archeologist will be liable for the GET on the services performed in Hawaii (60 hours).*

As in Example 4, assuming the archaeologist has nexus to Hawaii, the archeologist must pay general excise tax on all of his or her gross receipts from the Hawaii contractor for the services provided, and the local contractor is not subject to use tax. The archaeologist's services are used and consumed by the local contractor in Hawaii.

#### **IV. "Contracting" and "Service business or calling" defined**

Section 237-29.53, HRS, provides a general excise tax exemption for gross income derived from contracting or from a service business or calling that is exported out-of-state. "Contracting" is defined as the business activities of a contractor." HAW. REV. STAT. § 237-6. A contractor is defined as:

- (1) Every person engaging in the business of contracting to erect, construct, repair, or improve buildings or structures, of any kind or description, including any portion thereof, or to make any installation therein, or to make, construct, repair, or improve any highway, road, street, sidewalk, ditch, excavation, fill, bridge, shaft, well, culvert, sewer, water system, drainage system, dredging or harbor improvement project, electric or steam rail, lighting or power system, transmission line, tower, dock, wharf, or other improvements;
- (2) Every person engaging in the practice of architecture, professional engineering, land surveying, and landscape architecture, as defined in section 464-1; and
- (3) Every person engaged in the practice of pest control or fumigation as a pest control operator as defined in section 460J-1.

HAW. REV. STAT. § 237-6.

"Service business or calling" includes all activities engaged in for other persons for a consideration which involve the rendering of a service, including professional and transportation services, as distinguished from the sale of tangible property or the production and sale of tangible property." HAW. REV. STAT. § 237-7. It "does not include the services rendered by an employee to the employee's employer." HAW. REV. STAT. § 237-7.

The same taxpayer may be engaged in both contracting and in a service business or calling, depending on the work performed. For instance, an architect or engineer is engaged in contracting when managing a construction project; and is engaged in a service business or calling when performing a feasibility study or other consultation that is unrelated to a specific construction job. See Hawaii Tax Facts 99-3.

## V. Credit for Taxes Paid to Another State or Subdivision Thereof

Sections 237-22(b) and 238-3(i),<sup>4</sup> HRS, provide a credit for sales, gross receipts, or use taxes paid to another state with respect to the same transaction that is being subjected to Hawaii's general excise or use tax.<sup>5</sup> The credit cannot exceed the tax amounts previously paid upon the transaction to the other state or subdivision thereof, nor may it exceed the applicable rate of the Hawaii general excise or use tax. Therefore, the maximum credit that may be claimed is the lesser of the sales/use tax paid to the other state or the general excise or use tax due to the Department with respect to the same transaction. The Department of Taxation requires proof of payment of the tax, such as a sales invoice showing the taxes paid.<sup>6</sup>

The following examples illustrate the application of the credit against general excise and use taxes:

**Example 1:** Taxpayer, a New Mexico-based consulting company, is hired by a Hawaii retailer for a contract price of \$1,000. Taxpayer performs its services in New Mexico, which imposes a gross receipts tax at the rate of 5% upon consulting services. Taxpayer's accounting records substantiate the 5% gross receipts tax paid to New Mexico for its contract with the Hawaii retailer. Taxpayer regularly travels to Hawaii to meet with and provide support to its Hawaii customers, including the Hawaii retailer, establishing nexus to Hawaii. Taxpayer is subject to Hawaii's general excise tax at the rate of 4%.<sup>7</sup> Because the credit is limited to the general excise tax imposed by Hawaii, the credit is equal to \$40 (or 4% of the value of the services), rather than the \$50 that Taxpayer actually paid for New Mexico taxes.<sup>8</sup> Although Taxpayer's net Hawaii general excise tax liability with respect to the transaction with the Hawaii retailer is zero as a result of the credit, Taxpayer must still file a general excise tax return and claim the credit on such return.

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4 Section 238-3(i), HRS, provides as follows:

(i) Each taxpayer liable for the tax imposed by this chapter on tangible personal property, services, or contracting shall be entitled to full credit for the combined amount or amounts of legally imposed sales or use taxes paid by the taxpayer with respect to the same transaction and property, services, or contracting to another state and any subdivision thereof, but such credit shall not exceed the amount of the use tax imposed under this chapter on account of the transaction and property, services, or contracting. The director of taxation may require the taxpayer to produce the necessary receipts or vouchers indicating the payment of the sales or use tax to another state or subdivision as a condition for the allowance of the credit.

HAW. REV. STAT. §238-3(i).

5 A tax paid for manufacturing, extraction, or other taxes that are not sales or use taxes may not be used as a credit against the Hawaii general excise or use tax.

6 The required documents proving that taxes were paid to another state should be maintained and furnished upon the Department's request.

7 The Oahu county surcharge of .5% will apply, where applicable. See HAW. REV. STAT. § 237-8.6 and HAW. ADMIN. RULES §§ 18-237-8.6-01, et seq.

8 If the Oahu county surcharge tax is applicable, the credit is \$45 (or 4.5% of the value of the services).

**Example 2:** Assume the same facts as in Example 1, except that Taxpayer is subject to a gross receipts tax at the rate of 3% (or \$30), as evidenced by Taxpayer's accounting records. Because the credit is limited to the gross receipts tax imposed by New Mexico, the credit is equal to \$30 (or 3% of the value of services) and Taxpayer is liable for \$10 in Hawaii general excise taxes (\$40 Hawaii general excise tax less \$30 credit for New Mexico gross receipts tax).

**Example 3:** Assume the same facts as in Example 1, except that Taxpayer is hired to produce printed brochures and New Mexico imposes a manufacturing tax (which is not comparable to a sales tax) at the rate of 3% on the transaction. Taxpayer paid the tax as evidenced by Taxpayer's accounting records. Taxpayer is subject to general excise tax at the rate of 4% upon the value of the printing and provision of the brochures (\$40). Taxpayer is not allowed to claim a credit for the manufacturing taxes it has paid to New Mexico because a manufacturing tax is not a sales, gross receipts, or use tax.

**Example 4:** Taxpayer, a Hawaii business, engages a marketing consultant for a contract price of \$1,000. The consultant performs its services in New Mexico, which imposes a gross receipts tax at the rate of 5% upon consulting services. The consultant's sales invoice shows the sales price of the services and the 5% tax upon the services rendered (\$1,000 plus \$50). Assuming the consultant has no nexus to Hawaii, the Taxpayer is subject to the 4% use tax upon the value of the imported services, but may claim a credit for the New Mexico taxes paid with respect to that transaction. Because the credit is limited to the use tax imposed upon the importation of the services, the credit is equal to \$40 (or 4% of the value of the services), rather than the \$50 that Taxpayer actually paid for New Mexico taxes.

**Example 5:** Assume the same facts as in Example 4, except that the consultant is subject to a gross receipts tax at the rate of 3% (or \$30), which Taxpayer paid as evidenced by a sales invoice. Assuming the consultant has no nexus to Hawaii, the Taxpayer is subject to the use tax at the rate of 4% upon the value of the imported services, but may claim a credit for the New Mexico taxes paid with respect to that transaction (i.e., \$30). Taxpayer is liable for \$10 (\$40 Hawaii use tax less \$30 credit for New Mexico gross receipts tax) in Hawaii use taxes.

**Example 6:** Assume the same facts as in Example 4, except that the consultant is hired to produce printed brochures and is subject to a manufacturing tax (which is not comparable to a sales tax) at the rate of 3%. Taxpayer paid the tax as evidenced by a sales invoice. Taxpayer is subject to the use tax at the rate of 4% upon the value of the printed brochures (\$40), which it has imported for its own consumption. Taxpayer is not allowed to claim a credit for the manufacturing taxes it has paid because a manufacturing tax is not a sales, gross receipts, or use tax.

## **VI. Framework for Proposed Administrative Rules**

The following analysis should be used to determine whether the exported services exemption applies or whether the use tax on imported services must be paid:

- (1) Are the contracting or services "used or consumed" in Hawaii?
  - a. If "YES," the transaction is subject to either the general excise tax or the use tax. Go to (2).
  - b. If "NO," the transaction is not subject to either the general excise tax or the use tax.<sup>9</sup>
  - c. If "BOTH" (i.e., services used or consumed both within and outside of Hawaii), then, under certain circumstances as described above, that portion of the gross receipts from the transaction for which the contracting or services are "used or consumed" in Hawaii is subject to either the general excise tax or the use tax. See HAW. REV. STAT. § 237-21. Go to (2).
  
- (2) Does the contractor or service provider have nexus to Hawaii?
  - a. If "YES," then the contractor or service provider must pay general excise tax on its gross receipts with respect to contracting and services used or consumed in Hawaii, unless a specific exemption applies (e.g., section 237-26, HRS, "Exemption of certain scientific contracts with the United States").
  - b. If "NO," then the Hawaii importer must pay use tax with respect to contracting and services imported into Hawaii, unless a specific exemption applies (e.g., exemption for contracting services imported by a contractor provided in section 238-1, HRS, paragraph (10) of definition of "use").

See Exhibit A for a diagram illustrating the above analysis.

## **VII. Notice of Proposed Rules**

Effective immediately, the Department will be pursuing the promulgation of administrative rules that provide additions and amendments to Chapter 237 (general excise tax law) and Chapter 238 (use tax law), HRS, as herein described.

In order to ensure optimal compliance with the revenue laws, as well as to provide guidance to the tax community, the Department is issuing this TIR, which is comprised in substantial part of the proposed administrative rules the Department will be promulgating, upon which taxpayers may rely as discussed herein.

## **VIII. Invitation For Public Comment**

The Department invites the public to comment on the proposed rules accompanying this TIR by August 1, 2009.

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<sup>9</sup> As required by section 237-29.53, HRS, the seller claiming the GET exemption for exported contracting or services must obtain an "Export Exemption Certificate," Form G-61 (or an equivalent certification), from its customer.

Public comments may be sent to the following address:

Jodene K. Arakaki  
Administrative Rules Specialist  
Rules Office  
Department of Taxation  
P.O. Box 259  
Honolulu, Hawaii 96813  
Telephone: (808) 587-1481  
Fax: (808) 587-1584  
Email: [Jodene.K.Arakaki@hawaii.gov](mailto:Jodene.K.Arakaki@hawaii.gov)

**IX. Administrative Position of the Department; Reliance**

This TIR and the accompanying proposed administrative rules serve as the Department's position on the administration of sections 237-29.53 and 238-2.3, HRS. Taxpayers may rely upon this TIR and the accompanying proposed administrative rules to the extent taxpayers are authorized to rely upon TIRs generally as the Department's administrative interpretation. The Department will be enforcing its position as described in this TIR and the accompanying proposed administrative rules accordingly.

**X. Effective Date**

TIR Nos. 98-9 and 2001-2 are retroactively revoked and this TIR is retroactively effective pursuant to the enactment of Act 98, Session Laws of Hawaii. The accompanying proposed administrative rules are effective immediately. The portion of this TIR comprised of the proposed administrative rules will be obsolete upon the formal adoption of such rules.

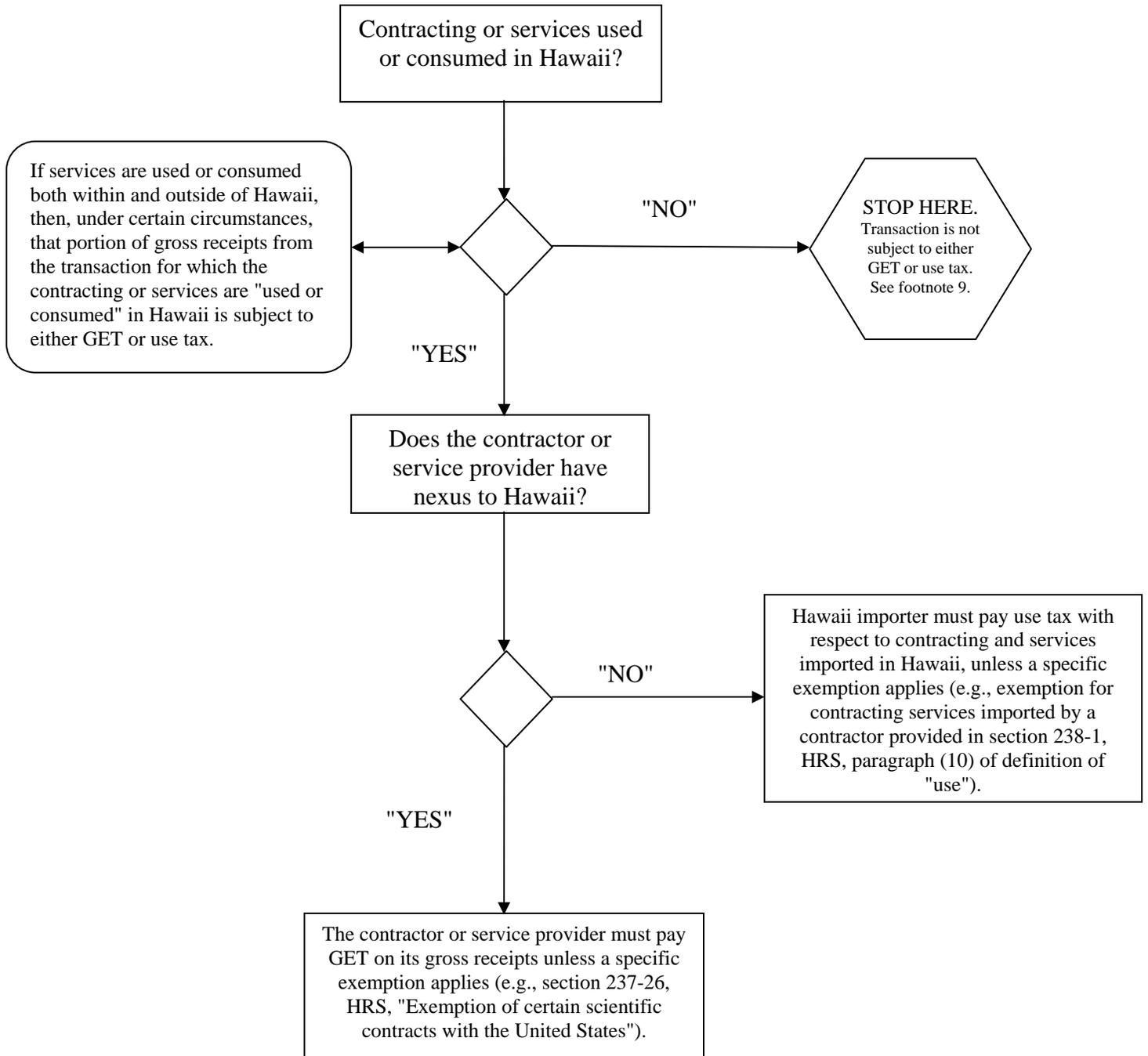


Kurt Kawafuchi  
Director of Taxation

HRS Sections Explained: 237-29.53 and 238-2.3.  
TIR Nos. 98-9 and 2001-2 are superseded.

EXHIBIT "A"

DIAGRAM OF EXPORTED/IMPORTED CONTRACTING AND SERVICES  
GENERAL EXCISE AND USE TAX ANALYSIS



DEPARTMENT OF TAXATION

Proposed Hawaii Administrative Rules

SUMMARY

**Proposed Administrative Rule Applying HRS §237-29.53**

§18-237-29.53

Exemption for contracting or services exported out-of-state

DEPARTMENT OF TAXATION

Proposed Hawaii Administrative Rules

Title 18

DEPARTMENT OF TAXATION

Chapter 237

General Excise Tax Law

**§18-237-29.53 Exemption for contracting or services exported out of state**

(a) Gross receipts from contracting (as defined under section 237-6, Hawaii Revised Statutes (HRS)) or services performed by a person engaged in a service business or calling in the State is exempt from general excise tax if the contracting or services are intended to be used or consumed outside of the State.

(b) Contracting or services are intended to be used or consumed outside of the State if the purchaser ultimately uses or receives the primary benefit of the acquired contracting or services outside of the State.

(c) The purchaser ultimately uses or receives the primary benefit of the acquired contracting outside of the State if the real property to which the contracting activity relates is situated outside of the State.

(d) The following factors will be considered in determining whether the purchaser ultimately uses or receives the primary benefit of the acquired services outside of the State:

- (1) Whether the purchaser's residence (if the purchaser is an individual) or commercial domicile (if the purchaser is a business entity) is located outside of the State. As defined by section 235-21, HRS, a purchaser's commercial domicile is the principal place from which the trade or business of the taxpayer is directed or managed.
- (2) Whether the services were acquired primarily for the benefit of the purchaser's overall business activities or specific business activities (if the

purchaser conducts business activities in more than one state), and to what extent, if any, a purchaser's Hawaii business activities directly and substantially benefit from the services provided.

No single factor is determinative and all facts and circumstances will be considered in determining whether the purchaser ultimately uses or receives the primary benefit of the acquired services outside of the State.

(e) If the purchaser is engaged in business activities in the State and outside of the State and the services are provided for the benefit of the purchaser's out-of-state business activities, any insubstantial, indirect benefit received by a purchaser's Hawaii business activities will be disregarded in applying this exemption, pursuant to section 237-21, HRS. Conversely, gross receipts from services will be subject to general excise tax based upon the direct and substantial benefit realized by a purchaser's Hawaii business activities from the services provided.

- (1) Any reasonable method of apportioning gross receipts based on direct and substantial benefits realized by a purchaser's Hawaii activities may be used, provided that such method is supported by verifiable data that reasonably quantifies the proportionate benefit realized by a purchaser's Hawaii activities.
- (2) All facts and circumstances will be considered in determining whether the Hawaii activities of a multi-state business directly and substantially benefits from the services provided, including, but not limited to, the nature and purpose of the service provided in relation to Hawaii business activities and whether the service provided represents overhead for the purchaser's commercial domicile.

(f) If a purchaser receives multiple substantial and direct benefits that are traceable and identifiable to business activities both within and outside of the State, gross receipts from the services provided will be subject to general excise tax in proportion to the direct and substantial benefit realized by the purchaser in Hawaii from the services provided.

(g) Application of the principles cited in this section is illustrated by the following examples:

**Example 1:** TP, a Hawaii attorney, is hired by Emma Entrepreneur, a Colorado resident who owns stock and partnership interests in various enterprises, as well as Hawaii real estate, to prepare her estate plan. TP and Emma have meetings at TP's offices in Hawaii and correspond via the email and over the phone to discuss Emma's estate plan. The legal fees that TP receives from Emma are exempt from general excise tax pursuant to section 237-29.53, HRS, as the services are used or consumed in Colorado, Emma's domicile.

**Example 2:** TP, a Hawaii attorney, is hired by Personal Representative to file and oversee an ancillary probate of Emma Entrepreneur's Hawaii estate (for additional real property purchased after Emma's estate plan was prepared, and for which title was taken individually and not in trust). Emma was domiciled in Colorado at her date of death. Personal Representative never travels to Hawaii with respect to the affairs of Emma's estate. All communications with Personal Representative are conducted via the phone or through mail. The legal fees that TP receives from Personal Representative are subject to general excise tax, and are not exempt from general excise tax pursuant to section 237-29.53, HRS, as the services are used or consumed in Hawaii, by the Hawaii ancillary probate.

**Example 3:** TP, a Hawaii market researcher, is hired by CHO Enterprises, a hotelier whose commercial domicile is in Nevada and who currently operates a Hawaii resort, to investigate expanding its resort operations in Hawaii. TP prepares a report and presents its finding to representatives of CHO Enterprises at CHO Enterprises' Nevada office. CHO Enterprises' existing Hawaii resort is expected to substantially benefit from the planned expansion. All of the fees that TP receives from CHO Enterprises are subject to general excise tax, and are not exempt from general excise tax pursuant to section 237-29.53, HRS, as the services are used or consumed in Hawaii.

**Example 4:** TP, a Hawaii employee benefits consultant, is hired by the corporate headquarters of a Washington-based

retailer, KSB Inc., to draft an employee handbook to be used by all of its corporate offices and retail stores, including a retail store located in Hawaii. The Hawaii retail store is a small percentage of KSB Inc.'s total number of retail stores and represents a small percentage of KSB Inc.'s overall revenues and profits. All of the fees that TP receives from KSB Inc. are exempt from general excise tax pursuant to section 237-29.53, HRS, because the Hawaii retail store indirectly and insubstantially benefits from the employee handbook.

**Example 5:** TP, a Hawaii real property management company, is hired by ACD Corporation, a Hawaii corporation, to manage a California property owned by ACD Corporation. All of the management fees that TP receives from ACD Corporation are exempt from general excise tax pursuant to section 237-29.53, HRS, because the management services are used and consumed in California, where the real property is situated.

**Example 6:** Hawaii Hotels Inc. ("HHI"), a Hawaii corporation that owns a hotel located on Oahu, hires Management Company ("MgmtCo"), a New York-based hotel management company, to manage and operate its Oahu hotel. As provided by the Agreement, HHI's hotel is operated under MgmtCo's brand name, 5 Star Resorts. Hotel personnel remain the employees of HHI, but represent to the public that they are employees of "5 Star Resorts On Waikiki Beach." MgmtCo reviews hotel operations, and provides on-going advice (in the areas of, e.g., human resources, marketing, grounds maintenance) on operating and maintaining a luxury hotel. HHI pays MgmtCo a fee for its services. MgmtCo infrequently visits Hawaii and provides advice to HHI from its corporate offices in New York. MgmtCo does not maintain an office in Hawaii; however, it has nexus with Hawaii through its agents and management contracts with HHI and other Hawaii-based hotels. All of the management fees received by MgmtCo from HHI are subject to general excise tax as the services are used and consumed on Oahu.

**Example 7:** TP, Hawaii-based software programmer, is hired by MSP, INC., a medical service provider that has activities in several states, including Hawaii, to write a customized and integrated patient file and billing program for use at all of its medical offices, including the office

located in Hawaii, for a fee of \$70,000. MSP's commercial domicile is located in California. TP installs the customized software at 7 of MSP's medical offices, of which 2 are located in Hawaii. There is no significant difference in the time or resources spent by TP on the installation at each location. MSP's Hawaii medical offices directly and substantially benefit from the creation and installation of the customized software. TP apportions 2/7 of its gross receipts received from MSP to Hawaii. The method of apportionment is reasonable. TP must report the full fee received from MSP, or \$70,000, in column (a) of Form G-45 and claim a \$50,000 deduction pursuant to section 237-29.53, HRS, for that portion of the fee apportioned out-of-state (or 5/7 of \$70,000).

**Example 8:** GSA Contractor, a general contractor that is a Hawaii corporation, is hired to perform general contracting services for a construction project located in Guam. Developer, the owner of the project, is a Hawaii corporation. Employees of GSA Contractor meet with Developer at Developer's Hawaii office on a weekly basis throughout the project's construction period to discuss project plans, progress, and other matters related to the project. All of the contracting revenues that GSA Contractor receives from Developer are exempt from general excise tax pursuant to section 237-29.53, HRS, because the contracting services are used or consumed in Guam, where the construction project is situated.

**Example 9:** ABC Insurance Co., a mainland corporation ("InsCo"), issues long-term disability insurance policies to individuals in Hawaii, as well as in other states. Its management company, XYZ Management Co., a mainland corporation ("MgmtCo"), services the policies, assisting policyholders in completing applications, filing claims, etc. InsCo's principal office is located in California. MgmtCo, whose principal office is located in California, has a Hawaii office staffed by employees who reside in Hawaii. MgmtCo's Hawaii office performs the initial work in reviewing applications and investigates claims before sending the documents to MgmtCo's principal office for final processing. InsCo pays MgmtCo a management fee for the services performed on InsCo's behalf. MgmtCo has nexus with Hawaii. The services performed by MgmtCo (in Hawaii and on the mainland) with respect to Hawaii policyholders

are used or consumed in Hawaii as InsCo's Hawaii business activities receive the primary benefit of MgmtCo's services. Thus, MgmtCo must pay general excise tax on 100% of the management fees it receives from InsCo with respect to servicing and managing policies held by Hawaii residents.

**Example 10:** Same facts as Example 9. MgmtCo also maintains a Colorado office to service InsCo's long-term disability insurance policies for Colorado residents. MgmtCo receives a lump sum monthly fee of \$50,000 from InsCo for the services it provides to both Hawaii and Colorado residents. MgmtCo allocates the fees received from InsCo to Hawaii based upon the number of insurance policies held by Hawaii residents (1,000, figured annually) in proportion to the total number of insurance policies held by Hawaii and Colorado residents (collectively, 1,500). The method of apportionment is reasonable. MgmtCo must report  $\frac{2}{3}$  ( $\frac{1,000}{1,500}$ ) of the monthly fee or \$33,333 in column (a) of Form G-45. It should not report the gross monthly fee of \$50,000 and a deduction of  $\frac{1}{3}$  of the monthly fee (for the portion attributable to Colorado) on Form G-45.

DEPARTMENT OF TAXATION

Proposed Hawaii Administrative Rules

SUMMARY

**Proposed Administrative Rule Applying HRS §238-2.3**

§18-238-2.3

Imposition of tax on imported services or contracting;  
exemptions

DEPARTMENT OF TAXATION  
Proposed Hawaii Administrative Rules

Title 18

DEPARTMENT OF TAXATION

Chapter 238

Use Tax Law

**Proposed Administrative Rule Applying HRS §238-2.3**

§18-238-2.3 Exemption for contracting or services exported out-of-state

**§18-238-2.3 Imposition of tax on imported services or contracting; exemptions** (a) The excise tax enumerated in section 238-2.3, HRS, is applied to the value of services or contracting as defined in section 237-6, Hawaii Revised Statutes (HRS), that are performed by an unlicensed seller at a point outside the State and imported or purchased for use or consumption in this State.

(b) Imported services or contracting are used or consumed in this State if the importer or purchaser ultimately uses or receives the primary benefit of the acquired contracting or services in the State.

(c) The importer or purchaser ultimately uses or receives the primary benefit of the acquired contracting in the State if the real property to which the contracting activity relates is situated in the State.

(d) The following factors will be considered in determining whether the purchaser ultimately uses or receives the primary benefit of the acquired services in the State:

- (1) Whether the purchaser's residence (if the purchaser is an individual) or commercial domicile (if the purchaser is a business entity) is located in the State. As defined by §235-21, Hawaii Revised Statutes, a purchaser's commercial domicile is the principal place from which the

trade or business of the taxpayer is directed or managed.

- (2) Whether the services were acquired primarily for the benefit of the purchaser's overall business activities or specific business activities (if the purchaser conducts business activities in more than one state), and to what extent, if any, a purchaser's non-Hawaii business activities directly and substantially benefit from the services provided.

No single factor is determinative and all facts and circumstances will be considered in determining whether the purchaser ultimately uses or receives the primary benefit of the acquired services in the State.

(e) If the purchaser is engaged in business activities in the State and outside of the State and the services are provided for the benefit of the purchaser's out-of-state business activities, any insubstantial, indirect benefit received by a purchaser's Hawaii business activities will be disregarded in applying this tax. Conversely, a purchaser will be subject to use tax based upon the direct and substantial benefit realized by a purchaser's Hawaii business activities from the services provided.

- (1) Any reasonable method of apportioning the value of the services based on direct and substantial benefits realized by a purchaser's Hawaii activities may be used, provided that such method is supported by verifiable data that reasonably quantifies the proportionate benefit realized by a purchaser's Hawaii activities.
- (2) All facts and circumstances will be considered in determining whether the Hawaii activities of a multi-state business directly and substantially benefits from the services provided, including, but not limited to, the nature and purpose of the service provided in relation to Hawaii business activities and whether the service provided represents overhead for the purchaser's commercial domicile.

(f) If a purchaser receives multiple substantial and direct benefits that are traceable and identifiable to business

activities both within and outside of the State of Hawaii, the value of services acquired will be subject to use tax in proportion to the direct and substantial benefit realized by a purchaser in Hawaii from the services provided.

(g) Application of the principles cited in this section is illustrated by the following examples, all of which assume the out-of-state service provider does not have nexus with Hawaii:

**Example 1:** TP, a Hawaii bank, contracts with a California-based storage and data back-up service to back-up and secure its data files. The California service provider performs its services via the internet. TP must pay the use tax on the value of the services provided because it receives the primary benefit of the back-up services at its office in Hawaii.

**Example 2:** TP, a Hawaii retailer with stores in Hawaii and California, retains a California employee benefits consultant to draft an employee handbook to be used by its corporate headquarters (located in Hawaii) and all of its retail stores. TP must pay use tax on all of the value of the services rendered by the California employee benefits consultant because it receives the primary benefit of the employee handbook at its corporate headquarters, which oversees personnel matters.

**Example 3:** TP, a Hawaii corporation with no out-of-state operations, hires a New York broker to manage its investment portfolio. TP pays investment advisory fees to the New York broker. TP must pay use tax on the value of the investment advisory services as it receives the primary benefit of the investment advice in Hawaii, where TP controls the brokerage account from its Hawaii office.

**Example 4:** TP, a Hawaii contractor, hires a California architect to design a building for a construction project located in Hawaii. The design services provided by the California architect are used or consumed in Hawaii. However, section 238-1(10), HRS, excludes from the definition of "use," contracting imported or purchased by a contractor, as defined in section 237-6, HRS, who is (1) licensed under chapter 237, HRS, (2) engaged in business as a contractor, and (3) otherwise subject to the tax imposed under section 238-2.3, HRS. Accordingly, TP does not have

to pay use tax on the imported contracting services provided by the California architect. However, TP may not claim a subcontractor deduction, pursuant to section 237-13(3), HRS, for payments to the California architect. Thus, if TP receives \$100,000 from the Owner of which TP pays \$10,000 to the California architect for the design services, TP must pay general excise tax on \$100,000 and is not entitled to a subcontract deduction of \$10,000.

**Example 5:** TP, a medical service provider that is commercially domiciled in Hawaii and has activities in Hawaii and California, hires a software programmer commercially domiciled in Washington to write a customized and integrated patient file and billing program for use at all of its medical offices, including the office located in Hawaii, for a fee of \$70,000. The customized software is used at 7 of TP's medical offices, of which 2 are located in Hawaii. There is no significant difference in the time or resources spent by the software programmer to install the program at each office via the internet. TP's Hawaii medical offices directly and substantially benefit from the creation and installation of the customized software. TP apportions 2/7 of the cost of the customized software to Hawaii and pays use tax only on such portion. Although TP's overall operations benefit from the customized software, the direct and substantial benefit is realized by each medical office. The method of apportionment is reasonable. TP must report and pay use tax on \$20,000 (or 2/7 of \$70,000) with respect to the services used and consumed in Hawaii.

**Example 6:** TP, Delaware corporation that is a nationwide retailer, hires a New York attorney to draft leases for its retail spaces in Hawaii and California. TP pays the New York attorney \$20,000 in legal fees with respect to the Hawaii leases. TP must report and pay use tax on \$20,000 with respect to the legal services used and consumed in Hawaii.

Refer to HAR § 18-237-29.53 and the examples contained in subsection (g) for application of the general excise tax to out-of-state businesses that import services into Hawaii and establish nexus with Hawaii.