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TAX INFORMATION RELEASE NO. 2009-04

RE: Application of Chapter 238, HRS (Use Tax Law), to Out-of-State Manufacturer-Retailers that are Similarly Situated to In-State Manufacturer-Retailers.

The purpose of this Tax Information Release (TIR) is to provide guidance on the application of Hawaii use tax to out-of-state licensed sellers that are manufacturer-retailer market participants when analyzed comparatively to in-state licensed sellers that are likewise manufacturer-retailer market participants. This TIR concludes that an out-of-state licensed seller that is a manufacturer-retailer may deduct from its use tax base the difference between the landed value of the taxpayer's own property and what would comprise the tax base of a similarly situated in-state licensed seller that is a manufacturer-retailer, as discussed herein.

I. USE TAX LAW, GENERALLY.

Chapter 238, Hawaii Revised Statutes (HRS), imposes a tax on the importation or use in the State of tangible personal property purchased from out-of-state sources. *See generally* HRS §§ 238-2, 238-3. "The general theory behind such a tax is 'to make all tangible property [or services] used or consumed in the State subject to a uniform tax burden irrespective of whether it is acquired within the State, making it subject to the [general excise] tax, or from without the State, making it subject to a use tax at the same rate.'" *In re Hawaiian Flour Mills, Inc.*, 76 Haw. 1, 13, 868 P.2d 419, 431 (1994) (citing *Halliburton Oil Well Cementing Co. v. Reily*, 373 US 64 (1963)). "The [use] tax buttresses the general excise tax as it is designed to prevent the avoidance of excise taxes through direct purchases from the mainland. Its ultimate purpose is to remove the competitive advantage an out-of-state wholesaler or retailer would otherwise have over a seller subject to the payment of State excise taxes." *In re Habilitat, Inc.*, 65 Haw. 199, 209, 649 P.2d 1126, 1133-34 (1982).

The base upon which the use tax is applied is to the "landed value" of property brought into the State, which "means the value of imported tangible personal property which is the fair and reasonable cash value of the tangible personal property when it arrives in Hawaii." HAR § 18-238-1. As amended by Act 114, Session Laws of Hawaii 2004, the use tax captures all importations of property, including property owned by the taxpayer prior to importation into Hawaii. *See* HRS § 238-2; *see also Baker & Taylor, Inc. v. Kawafuchi*, 103 Haw. 359, 82 P.3d 804 (2004).

II. *HALLIBURTON* AND THE ADMONISHMENT OF DISCRIMINATION IN FAVOR OF LOCAL BUSINESSES.

As a general matter, the Commerce Clause precludes the State from imposing a greater tax or regulatory burden on out-of-state businesses than an equivalent in-state business. In the use tax context, "[t]he burden on the out-of-state acquisition 'is balanced by an equal burden where the sale is strictly local,'" with each assessed a complimentary tax as the case may be. *Halliburton*, 373 US at 69 (citing *Hanneford v. Silas Mason Co.*, 300 US 577, 584). Halliburton therefore stands for the proposition that "equal treatment for in-state and out-of-state taxpayers similarly situated is the condition precedent for a valid use tax on goods imported from out-of-state." *Id*. at 70; *see also Hawaiian Flour Mills*, 76 Haw. at 13, 868 P.2d at 431.

As a result of the US and Hawaii Supreme Courts' use tax analyses, assessment of Hawaii's use tax will only be upheld where an out-of-state business is burdened with Hawaii taxation to the same extent as a similarly situated in-state business. In making the analysis of whether the use tax results in discrimination, "the whole scheme of taxation" is taken into account. *Halliburton*, 373 US at 69; *see also In re Otis Elevator Co.*, 58 Haw. 163, 174, 566 P.2d 1091, 1097 (1977).

III. ADMINISTRATIVE POWER TO CORRECT ACTUAL DISCRIMINATION; REQUIREMENT OF SIMILARLY SITUATED.

In order to ensure the use tax is applied fairly to both in-state and out-of-state similarly situated businesses, Chapter 238, HRS, provides the Director of Taxation with relief in assessing the use tax:

> The tax imposed by this chapter shall not apply to any property, services, or contracting or to any use of the property, services, or contracting that cannot legally be so taxed under the Constitution or laws of the United States, but only so long as, and only to the extent to which the State is without power to impose the tax.
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> To the extent that any exemption, exclusion, or apportionment is necessary to comply with the preceding sentence, the director of taxation shall:
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> (1) exempt or exclude from the tax under this chapter, property, services, or contracting or the use of property, services, or contracting exempt under chapter 237; or
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> (2) apportion the gross value of services or contracting sold to customers within the State by persons engaged in business both within and without the State to determine the value of that portion of the services or contracting that is subject to taxation under chapter 237 for the purposes of section 237-21.

HRS § 238-3. Importantly, before any discriminatory use tax relief may be sought or applied to an out-of-state business, the determination must be made that the business is "similarly situated" to an in-state taxpayer.

The "similarly situated" analysis requires comparison to "the very in-state taxpayer who is most similarly situated." *Halliburton,* 373 US at 71. Because the "similarly situated" determination is highly fact intensive, taxpayers must take care to compare their situations to an identical Hawaii taxpayer at all levels of the business taking into account the entire tax scheme, meaning application

of both the general excise and use taxes to both the in-state and out-of-state business. For a review of the fact intensive nature of the similarly situated analysis, *please see In re Hawaiian Flour Mills, Inc*., 76 Haw. 1, 868 P.2 419 ("HFM is essentially an intermediary….therefore HFM is similarly situated with local intermediaries."); and *In re Otis Elevator Co*., 58 Haw. 163, 566 P.2d 1091 ("[O]ur comparison must be between an in-state and an out-of-state vertically integrated manufacturer-contract-servicer.").

IV. FACTUAL SCENARIO ENTITLED TO APPLICATION OF USE TAX RELIEF FOR ACTUAL DISCRIMINATION BETWEEN SIMILARLY SITUATED IN-STATE AND OUT-OF-STATE MANUFACTURER-RETAILER LICENSED SELLERS.

The following factual scenario represents the industry participant entitled to use tax relief under this TIR—

> XYZ, Inc. is a California-based corporation with nexus in Hawaii and is a licensed seller for purposes of Hawaii general excise and use tax law. XYZ's business includes the cultivation and farming of agricultural products. All of XYZ's farming operations occur in California. XYZ's labor component of its agricultural product production is comprised entirely of employee labor and not independent contractors. XYZ also sells its own agricultural products at retail, which are imported into Hawaii for purposes of sale. Thus, XYZ is a manufacturer-retailer for purposes of this hypothetical. XYZ's only Hawaii business activity is the retail sale of its farm products produced in California and imported into Hawaii.
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> Similarly situated to XYZ, Inc. is ABC, LLC, a Hawaii-based limited liability company that is a licensed seller for purposes of Hawaii general excise and use tax law. ABC's business includes the cultivation and farming of agricultural products. Like XYZ, all of ABC's agricultural product production results from employee labor and not independent contractors. ABC also sells its own agricultural products at retail. All of ABC's farming and retailing activities occur in Hawaii. Thus, ABC is a manufacturer-retailer for purposes of this hypothetical.

V. USE TAX RELIEF ANALYSIS TO SIMILARLY SITUATED MANUFACTURER-RETAILER INDUSTRY PARTICIPANTS.

Taking into account the entire scheme of general excise and use taxation into account, XYZ, Inc. is entitled to use tax relief under the facts of this TIR.

Under current use tax law, a licensed seller is assessed a use tax for <u>any</u> importation of property based upon the property's landed value. This broad assessment includes a use tax assessed for property owned prior to importation. As applied to XYZ, the entire scheme of general excise and use taxation fundamentally discriminates against XYZ in favor of ABC—an in-state business.

XYZ will be assessed a use tax equal to the landed value of its produce imported into Hawaii for retail sale at the rate of 0.5% for importing produce that it manufactured, as discussed above, and owns at the time it enters the Hawaii taxing jurisdiction. The landed value of XYZ's produce includes the cost of seeds, as well as the value of XYZ's employee cultivating labor, packaging, and

the added value resulting from the growth of the seed into viable/saleable produce. When XYZ sells its products at retail, it will be subject to general excise tax at the rate of 4% for the same produce. Ultimately, after applying both general excise and use taxes, XYZ is taxed upon the base of the landed value of its produce at a combined tax rate (general excise and use) of 4.5%.

ABC as a similarly situated industry participant will be taxed upon a base more favorable than XYZ. As an in-state manufacturer-retailer, ABC's activities will be subject to either a use tax or general excise tax at the rate of 0.5% for the seeds used to create the viable produce, as well as the purchase of packaging material.[1] However, ABC will not be assessed a 0.5% tax on the added value resulting from the growth of the seeds into viable produce, nor the value of the employee labor from cultivating the produce. On the other hand, XYZ could potentially be subject to a 0.5% tax on these latter components—ABC will not. ABC will be subject to the general excise tax on the retail sale of its comparable produce at the same rate of 4%. Though ABC is taxed similarly at rates of 0.5% for wholesale purchases of items used to manufacture its produce and 4% for the retail sale of the produce, ABC's tax base is discriminatory in favor of the in-state business because its tax base will not include the added value, as discussed above, included in XYZ's tax base. XYZ could potentially have a higher tax base, which includes the components adding value under these facts (*i.e.*, employee cultivating labor and growth value).

Because XYZ's tax base could potentially include elements of value beyond what a similarly situated in-state manufacturer-retailer would be taxed (*i.e*., landed value of completed product vs. product components), XYZ is entitled to use tax relief under HRS § 238-3. Under the facts of this TIR, the appropriate relief under HRS § 238-3 is to remove from XYZ's tax base the difference between the landed value and the value of product components not taxable to an in-state manufacturer-retailer, which in this case would remove the value of employee cultivating labor and growth value, but not the seedlings, packaging material, or other potential product components taxed equally to the in-state and out-of-state taxpayers. *See e.g., Halliburton Oil Well Cementing Co. v. Reily*, 373 US 64 (1963).

VI. EFFECTIVE DATE & ADMINISTRATION OF ACT 114, SLH 2004.

This TIR takes effect immediately and applies to all years where the statute of limitations remains open for assessment or refund.

The Department will be administering amendments to HRS § 238-2 made by Section 3, Act 114, SLH 2004, on a prospective basis from June 10, 2004, which is the date Act 114 was approved by the Governor. Section 3 of Act 114 added the term "sale" to the use tax imposition for certain importers or purchasers. The Department will not apply Act 114's retroactive effective date to this addition.

KURT KAWAFUCHI
Director of Taxation

HRS Sections Explained: HRS §§ 238-1, 238-2, 238-3

[1] ABC's transaction will be taxed at either a 0.5% use tax for importation of seeds and packaging; or a 0.5% general excise tax assessed to the seller of the seeds and packaging if purchased locally. The type of tax is irrelevant as the assessments are complimentary.