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TAX INFORMATION RELEASE NO. 2020-01

RE: Proposed Administrative Rules Relating to market-based sourcing of gross receipts from services and intangibles as enacted by Act 96, Session Laws of Hawaii 2019

The purpose of this Tax Information Release (TIR) is to provide advanced notice of the proposed administrative rules relating to Act 96, Session Laws of Hawaii 2019 (Act 96). This TIR and the attached proposed administrative rules are effective from January 1, 2020 until the effective date of the administrative rules adopted in final form.

Act 96 was signed into law on June 7, 2019 and will became effective on January 1, 2020. Act 96 amended the sales factor sourcing rules for income from the sale of services and intangibles to market-based sourcing.

Market-based sourcing attributes gross receipts to the taxpayer’s market, which is generally where the taxpayer’s customers are located or where their products are used or consumed. This contrasts with prior sourcing rules for sales of services or intangibles, which generally attributed gross receipts to the state in which the taxpayer’s business activity took place.

The Department of Taxation (Department) has developed the attached rules to be consistent with the sourcing rules for services and intangibles under chapter 237, Hawaii Revised Statutes (HRS). Where practicable, the relevant rules under chapter 237, HRS, are incorporated by reference. These rules are sections 18-237-29.53-01 through 18-237-29.53-12 and section 18-237-29.57-01, Hawaii Admirative Rules. These rules can be found on the Department’s website at http://tax.hawaii.gov/legal/taxlawandrules.

The Department will be accepting public testimony regarding the proposed administrative rules through the formal rulemaking process, however, testimony may be submitted to the Rules Office before the formal process begins.

For more information, please contact the Rules Office at (808) 587-1530 or by email at tax.rules.office@hawaii.gov.

RONA M. SUZUKI
Director of Taxation

DEPARTMENT OF TAXATION

Amendments to Chapter 18-235
Hawaii Administrative Rules

_______________, 2020

1. Section 18-235-37-01, Hawaii Administrative Rules, is amended to read as follows:

§18-235-37-01 Sales factor; sales other than sales of tangible personal property in this State. (a) Section 235-37, HRS, provides for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States Government). Under this section, gross receipts from services are attributed to this State [~~if the income producing activity which gave rise to the receipts is performed wholly within this State. Also, gross receipts are attributed to this State if, with respect to a particular item of income, the income producing activity is performed within and without this State but the greater proportion of the income producing activity is performed in this State, based on costs of performance.~~] to the extent the service is used or consumed in this State. Under this section, gross receipts from intangibles are attributed to this State to the extent the intangible property is used in this State.

[~~(b) As used in this section:~~

~~"Costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.~~

~~"Income producing activity" applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profit. Income producing activity does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, income producing activity includes but is not limited to the following:~~

~~(1) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service;~~

~~(2) The sale, rental, leasing, licensing, or other use of~~

~~real property;~~

~~(3) The rental, leasing, licensing, or other use of tangible personal property; and~~

~~(4) The sale, licensing, or other use of intangible personal property.~~

~~The mere holding of intangible personal property is not, of itself, an income producing activity.~~

~~(c) Receipts (other than from sales of tangible personal property) in respect to a particular income producing activity are in this State if:~~

~~(1) The income producing activity is performed wholly within this State; or~~

~~(2) The income producing activity is performed both in and outside this State and a greater proportion of the income producing activity is performed in this State than in any other state, based on costs of performance.~~]

[~~(d) The following are special rules for determining when receipts from the income producing activities described below are in this State:~~

~~(1) Gross receipts from the sale, lease, rental, or licensing of real property are in this State if the real property is located in this State.~~

~~(2) Gross receipts from the rental, lease, or licensing of tangible personal property are in this State if the property is located in this State. The rental, lease, licensing, or other use of tangible personal property in this State is a separate income producing activity from the rental, lease, licensing, or other use of the same property while located in another state; consequently, if property is within and without this State during the rental, lease, or licensing period, gross receipts attributable to this State shall be measured by the ratio which the time the property was physically present or was used in this State bears to the total time or use of the property everywhere during that period.~~

~~Example:~~

~~Taxpayer is the owner of ten rental motor vehicles. During the year, the total of the days during which each motor vehicle was present in this State was fifty days. The receipts attributable to the use of each of the motor vehicles in this State are a separate item of income and shall be determined as follows:~~

$$\cancel{\frac{\text{10 vehicles x 50 days}}{\text{10 vehicles x 365 days}}} \;\cancel{\times}\; \cancel{\text{Total Receipts}} \;\cancel{=}\; \cancel{\text{Total Hawaii Receipts}}$$

~~(3) Gross receipts for the performance of personal services are attributable to this State to the extent that such services are performed in this State. If services relating to a single item of income are performed partly within and partly without this State, the gross receipts from the performance of such services shall be attributable to this State only if the greater proportion of the services were performed in this State, based on costs of performance. Usually, where services are performed partly within and partly without this State, the services performed in each state will constitute a separate income producing activity; in such cases, the gross receipts from the performance of services attributable to this State shall be measured by the ratio which the time spent in performing the services in this State bears to the total time spent in performing the services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to those gross receipts. Personal service not directly connected with the performance of the contract or other obligation, as for example time expended in negotiating the contract, is excluded from the computations.~~

~~Example 1:~~

~~Taxpayer, a road show, gave theatrical performances at various locations in State X and in this State during the tax period. All gross receipts from performances given in this State are attributed to this State.~~

~~Example 2:~~

~~The taxpayer, a public opinion survey corporation, conducted a poll by means of its employees in State X and in this State for the sum of $9,000. The project required six hundred employee hours to obtain the basic data and prepare the survey report. Two hundred of the six hundred employee hours were expended in this State. The receipts~~

~~attributable to this State are $3,000: 200 x $9,000 = $3,000 600.~~]

(b) Subject to modification by these rules, gross receipts from sales of services or intangibles to a purchaser in this state who resells the services or intangibles are attributable to this State unless the purchaser resells all of the services or intangibles for use or consumption outside this State.

(c) If services or intangibles are used or consumed both inside and outside this State, the gross receipts are attributable to this State in proportion to the benefit received in this State. Any reasonable method of apportionment may be used; provided that the method is consistently used by the taxpayer and supported by verifiable data that reasonably quantifies the proportionate benefit received in this State.

(d) For purposes of this section, sections 18-237-29.53-01 through 18-237-29.53-12, as adopted on March 17, 2018, are incorporated by reference, subject to any modifications by these rules.

(e) For purposes of this section, section 18-237-29.57-01, as adopted on April 20, 2019, is incorporated by reference, subject to any modifications by these rules.

(f) The following principles shall apply for purposes of applying the administrative rules incorporated by reference above:

(1) The conclusion "not exempt under section 237-29.53" means that the gross receipts deemed not exempt are attributed to this state.

(2) The conclusion "exempt under section 237-29.53" means that the gross receipts deemed exempt are not attributed to this state.

Example:

Example 8 under section 18-237-29.53-11 concludes that "All of the value or gross income that GD Company receives from Honolulu Hut is not exempt under section 237-29.53." For purposes of these rules, Example 8 and its conclusion require that GD Company attribute the gross receipts it receives from Honolulu Hut to this state.

(g) Nothing in this section shall limit the application of, or authority granted to the director under, section 237-38, Hawaii Revised Statutes, or the administrative rules promulgated thereunder. If there is a conflict between this section and the administrative rules promulgated under section 237-38, Hawaii Revised Statutes, the administrative rules under section 237-38, Hawaii Revised Statutes, control.

[Eff 11/25/94; am] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §§235-37, 235-38)

2. Section 18-235-38-03, Hawaii Administrative Rules, is amended to read as follows:

§18-235-38-03 Special rules; sales factor. (a) Where substantial amounts of gross receipts arise from an occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

(b) Insubstantial amounts of gross receipts arising from occasional transactions or activities may be excluded from the sales factor unless their exclusion would materially affect the amount of income apportioned to this State. For example, the taxpayer ordinarily may include in or exclude from the sales factor gross receipts from transactions such as the sale of office furniture or business motor vehicles.

(c) In subsections (a) and (b), a transaction qualifying as a casual sale as defined in section 237-1, HRS, and section 18-237-1 shall be considered an occasional transaction.

[~~(d) Where the income producing activity in respect to business income from intangible personal property can be readily identified, the income is included in the denominator of the sales factor and, if the income producing activity occurs in this State, in the numerator of the sales factor as well. For example, usually the income producing activity can be readily identified in respect to interest income received on deferred payments on sales of tangible property (section 18-235-35-01(a)(1)) and income from the sale, licensing, or other use of intangible personal property (section 18-235-37-01(b)(4)).~~]

<u>(d) Where the place of use of intangible personal property or place of use or consumption of services is attributed to a state in which the taxpayer is not taxable, then the gross receipts attributable to the state in which the taxpayer is not taxable shall be excluded from the denominator of the sales factor.</u>

(e) Where [~~business income~~] <u>gross receipts</u> from intangible property cannot readily be attributed to any particular [~~income producing activity of the taxpayer,~~] <u>place of use,</u> the [~~income~~] <u>gross receipts</u> cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, where [~~business income~~] <u>gross receipts</u> in the form of dividends received on stock, royalties received on patents or copyrights, or interest received on bonds, debentures, or government securities results from the mere holding of the intangible personal property by the taxpayer, the dividends and interest shall be excluded from the denominator of the sales factor. Income from a foreign affiliate as defined in section 18-235-38.5-02, including dividends from a foreign affiliate and interest paid on intercompany loans, shall be excluded from the denominator of the sales factor.

(f) Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under this section, such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.

(1) For purposes of subsection (f), a "liquid asset" is an asset (other than functional currency or funds held in bank accounts) held to provide a relatively immediate source of funds to satisfy the liquidity needs of the trade or business. "Liquid assets" include foreign currency (and trading positions therein) other than functional currency used in the regular course of the taxpayer’s trade or business; marketable instruments (including stocks, bonds, debentures, options, warrants, futures contracts, etc.); and mutual funds which hold such liquid assets. An instrument is considered marketable if it is traded in an established stock or securities market and is regularly quoted by brokers or dealers in making a market. Stock in a corporation which is unitary with the taxpayer, or which has a substantial business relationship with the taxpayer is not considered marketable stock.

(2) For purposes of subsection (f), a "treasury function" is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer’s business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

(3) For purposes of subsection (f), "overall net gain" refers to the total net gain from all transactions incurred at each treasury function for the entire tax period, not the net gain from a specific transaction.

Example 1:

A taxpayer manufactures various gift items. Because of seasonal variations, the taxpayer must keep liquid assets available for later inventory acquisitions. Because the manufacturer wants to obtain a return on available funds, the manufacturer acquires liquid assets, which are held and managed in this State. The net gain resulting from all gains and losses on the sale of the liquid assets for the tax year will be reflected in the denominator of the sales factor and in the numerator of this State.

Example 2:

A stockbroker acts as a dealer or trader for its own account in its ordinary course of business. Some of the instruments sold are liquid assets. This subsection does not operate to classify those sales as attributable to a treasury function. [Eff 11/25/94; am 9/8/98; am] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §§235-35 to 235-38)

3. Material to be repealed is bracketed and stricken. New material is underscored.

4. These amendments to chapter 18-235, Hawaii Administrative Rules, shall take effect ten days after filing with the Office of the Lieutenant Governor.