

DEPARTMENT OF TAXATION

Amendments to Chapter 18-237 and Sections 18-238-1 and 18-238-2
Hawaii Administrative Rules

April 20, 1998

SUMMARY

1. A new 18-237-13-02.01 is added.
2. § 18-238-1 is amended.
3. § 18-238-2 is amended.

§18-237-13-02.01 **Tax on business of selling tangible personal property by an out-of-state seller, including drop shipments.** (a) For the purposes of this section:

"Accept or Acceptance" means the purchaser or its agent inspecting the tangible personal property and taking physical possession of the tangible personal property or having dominion and control over the tangible personal property.

"Agent" means a person authorized by the purchaser to act on behalf of the purchaser and includes the power to inspect and accept or reject the tangible personal property.

"Delivery" means the act of transferring possession of tangible personal property. It includes, the transfer of goods from consignor to freight forwarder or for-hire carrier, from freight forwarder to for-hire carrier, one for-hire carrier to another, or for-hire carrier to consignee.

"Drop Shipment", sometimes known as direct delivery, means the delivery and acceptance of tangible personal property by a customer in Hawaii from a manufacturer or wholesaler who is someone other than the seller with whom the customer placed the order.

"Landed value" 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. It includes the sales price, shipping and handling fees, insurance costs, and customs duty. It does not include sales tax paid to another state.

"Nexus" means the activity carried on by a seller in Hawaii which is sufficiently connected with the seller's ability to establish or maintain a market for its products in Hawaii. It includes issues of taxability addressed under the Due Process and Commerce Clauses of the United States Constitution to support the application of the general excise tax and the use tax under chapters 237 and 238, HRS, respectively.

"Place of delivery" means the state or place where the purchaser or its agent accepts a delivery of tangible personal property.

(b) Imposition of general excise tax on sales of tangible personal property to customers in Hawaii. Section 237-13, HRS, imposes "privilege taxes against persons on account of their business and other activities in the State" Section 237-2, HRS, states that "business" includes "all activities (personal, professional, or corporate), engaged in or caused to be engaged in with the object of gain or economic benefit either direct or indirect"

- (1) The act or place of passing of title is not the determinative factor for purposes of imposing the general excise tax. In states imposing a retail sales tax where a sale is defined as the transfer of title or ownership, the place where title passes may be relevant. The general excise tax, however, is not a sales tax imposed when title passes. Rather, the general excise tax is a gross receipts tax imposed when business is transacted in Hawaii.
- (2) The general excise tax law looks to the place of delivery of tangible personal property to determine whether the sale of tangible personal property is business transacted in Hawaii.
- (3) Hawaii does not impose the general excise tax on sales of tangible personal property which originate outside of this State unless the place of delivery of the tangible personal property is in Hawaii and the seller has nexus. There must be both: (1) a place of delivery within Hawaii by the purchaser, or its agent; and (2) the seller must have nexus for the general excise tax to apply to a particular sale. The general excise tax will not be imposed if one of these elements is

missing.

- (4) Delivery of tangible personal property to a freight consolidator, freight forwarder, or for-hire carrier utilized only to arrange for and/or transport the tangible personal property does not constitute acceptance of the tangible personal property by the purchaser or its agent unless the freight consolidator, freight forwarder, or for-hire carrier has expressed written authority to accept the tangible personal property as an agent for the purchaser. Simply signing the bill of lading without this expressed written authority is not sufficient.
- (5) When the place of delivery of the tangible personal property is to a customer in Hawaii and the seller has nexus, the sale of that tangible personal property constitutes business subject to the general excise tax. Section 237-22, HRS, states that gross income or gross proceeds of sale will be exempt if the State is prohibited from taxing the gross income under federal law or constitutional principles. If an out-of-state seller has no nexus with Hawaii, its gross income or gross proceeds of sale would be exempt under section 237-22, HRS.

(c) Imposition of the use tax on the sale of tangible personal property to a customer in Hawaii. Section 238-2, HRS, imposes use tax "on the use in this State of tangible personal property which is imported . . . for use in the State" if it is purchased from a seller that does not have a general excise tax license. All tangible personal property used or consumed in the State is subject to a uniform tax burden irrespective of whether it is acquired within or without the State.

- (1) The use tax is levied on the importer of tangible personal property based upon the landed value of the tangible personal

property imported.

- (2) The tax rate is one-half of one per cent if the tangible personal property is intended for resale at retail, four per cent if the tangible personal property is intended for consumption or use by the importer or purchaser, or no tax if the tangible personal property is intended for resale to a reseller licensed under the general excise tax law.

(d) The liability for paying the general excise tax or the use tax is dependent on all the factual circumstances.

(e) The following is an example involving two parties and is treated as a single transaction.

Example: S, an out-of-state seller of tangible personal property, receives an order over the telephone or through the mail, from H, a Hawaii customer who is the ultimate consumer. H requests that the tangible personal property be delivered to H in Hawaii. S ships the tangible personal property for delivery to and acceptance by H in Hawaii.

The additional fact as to whether or not S has nexus with Hawaii determines the result in this example:

- (1) If S has nexus with Hawaii, S's sale of tangible personal property constitutes business in Hawaii for purposes of the general excise tax law. As a result, S must obtain a general excise/use tax license. S is considered the importer for resale at retail and is subject to the use tax at one-half of one per cent. S is also subject to the general excise tax at four per cent on the sale.
- (2) If S does not have nexus with Hawaii, pursuant to section 237-22, HRS, the general excise tax is not imposed upon S. Because S is not a licensed seller and the import is

for consumption by H, H is subject to the use tax at four per cent.

(f) The following is an example of a drop shipment that involves three parties and is treated as two separate transactions.

Example: S, an out-of-state seller of tangible personal property, receives an order over the telephone or through the mail, from H, a Hawaii customer who is the ultimate consumer. W is an out-of-state wholesaler of tangible personal property. S notifies W of the order and requests that W ship the tangible personal property directly to H in Hawaii. W then ships the tangible personal property for delivery to and acceptance by H in Hawaii.

The following are the results when differing additional facts as to whether S and W have nexus with Hawaii and are properly licensed under the general excise tax law are incorporated into the example:

- (1) If neither S nor W has nexus with Hawaii and both are unlicensed, the importation of the tangible personal property by H is from an unlicensed seller for consumption. H is subject to the use tax at four per cent.
- (2) If S has nexus with Hawaii and is licensed but W is unlicensed and has no nexus, S is considered to have imported the tangible personal property for resale at retail and is subject to the use tax at one-half of one per cent. The sale from S to H is a retail sale. S's gross income from the sale is subject to the general excise tax at the rate of four per cent.
- (3) If both S and W have nexus with Hawaii and are licensed, both sales would be subject to the general excise tax. The sale from W to S is a wholesale sale. W's gross income is taxable at one-half of one per cent. The

sale from S to H is a retail sale. S's gross income is taxable at four per cent. There is no use tax because W imported the tangible personal property for resale to a licensed reseller.

- (4) If W has nexus with Hawaii and is licensed but S is unlicensed and has no nexus, the sale from W to S does not qualify as a wholesale sale under section 237-4(1), HRS, because S is not a licensed seller for general excise purposes, therefore, W is subject to the general excise tax at the rate of four per cent. W is considered to have imported the tangible personal property for resale at retail and is subject to the use tax at of one-half of one per cent. The general excise tax is not imposed on the sale from S to H because S does not have sufficient nexus with Hawaii. Since W is the importer of the tangible personal property and H is not, H would not be subject to the

use tax. [Eff **MAY 26, 1998**] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §§237-4(1), 237-13(2), 237-21, 237-22, 238-2, 238-3(c))

§18-238-1 **Definitions.** For purposes of this chapter:

"Consummated" is the place of delivery meaning the state or place where the purchaser or its agent accepts a delivery of tangible personal property.

"Landed value" 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. It includes the purchase price, shipping and handling fees, insurance costs, and customs duty. It does not include sales tax paid to another state.

"Place of delivery" means the state or place where the purchaser or its agent accepts a delivery of tangible personal property.

"Price" means the total amount for which tangible personal property is purchased, valued in money, whether paid in money or otherwise, and wheresoever paid, provided that cash discounts, trade and quantity discounts allowed and taken on sales shall not be

included. [Eff **MAY 26, 1998**] (Auth: HRS §§231-3(9), 238-16) (Imp: HRS §238-1)

18-238-2 **Imposition of tax, exemptions.** (a) Wholesaler, jobber, manufacturer. Section 238-2(1), HRS, provides that if the importer or purchaser is licensed under the general excise tax law, chapter 237, HRS, and is (1) a wholesaler or jobber, importing or purchasing tangible personal property exclusively for the purposes of resale at wholesale or (2) a manufacturer importing or purchasing material to be incorporated by the manufacturer into a finished product, which, when sold, will result in a further tax on the activity of the manufacturer as a manufacturer or as a wholesaler, and not as a retailer, there shall be no tax. If the importer or purchaser as set forth in (1) or (2) above is also engaged in business as a retailer, subsection (b) shall apply to the importer or purchaser, but the director shall refund to the importer or purchaser in the manner provided under section 231-23(d), HRS, such amount of tax as the importer or purchaser shall, to the satisfaction of the director, establish to have been paid by the importer or purchaser on such imports or purchases which were sold by the importer or purchaser as a wholesaler or as a manufacturer. See subsection (h) for deduction and credit procedures, other than refund method provided in section 231-23(d), HRS, which a wholesaler or manufacturer who is also a retailer is permitted to use in determining tax liability under chapter 238, HRS.

(b) Retailer or any other person not exempted by subsection (a). Section 238-2(2), HRS, provides that if the importer or purchaser is licensed under the general excise tax law, chapter 237, HRS, and is (1) a retailer or other person importing or purchasing for purposes of resale and not exempted by subsection (a), or (2) a manufacturer as set forth in subsection (a)(2) except for the fact that the manufacturer sells his products at retail, or (3) a contractor incorporating imported or purchased material or commodities into the finished work or project, the tax shall be one-half of one per cent of the purchase price of such tangible

personal property, if the purchase and sale are consummated in Hawaii, or, if there is no purchase price applicable thereto, or if the purchase or sale is consummated outside of Hawaii, then one-half of one per cent of the landed value of such property imported into Hawaii. For taxes on sales of tangible personal property by an out-of-state seller, including drop shipments and definitions, see §18-237-13-02.01. See subsection (g) for rules relating to basis of property.

(c) Certain scientific contracts with the United States. Notwithstanding the provisions of subsection (b) of this rule, the tax imposed by chapter 238, HRS, shall not apply to any use of property exempted by section 237-26, HRS. Thus, no use tax shall be levied or collected on tangible personal property which is to be affixed to, or to become a physical, integral part of the scientific facility, or which is to be entirely consumed during the performance of the service required by the contract or subcontract.

(d) All others. HRS section 238-2(3) provides that in all other cases, the tax shall be four per cent of the landed value of such tangible personal property. For taxes on sales of tangible personal property by an out-of-state seller, including drop shipments and definitions, see §18-237-13-02.01. See subsection (g) for rules relating to basis of property.

(e) Producers. See §18-238-4 relating to producers.

(f) Application of the rules contained in subsections (a), (b), (c), (d) and (e) of this section may be illustrated by the following examples.

Example 1: "A" purchases and imports a container load of merchandise from an out-of-state seller for resale in Hawaii to "X", a retail discount store. "A's" records further disclose that other imports and purchases made by "A" are sold to various other retail stores. Thus, because all sales are at the wholesale level, all

such imports and purchases from an out-of-state seller are exempt from the use tax.

Example 2: "B", who is in the business of manufacturing food items, imports food preservatives and food containers. The preservatives are to be incorporated into the manufactured product while the containers are used to make the finished product marketable. "B" has an agreement to sell all of his manufactured products exclusively to "S", a large retail supermarket with many branches. Because all sales are at the wholesale level, "B" is exempt from the use tax. "B", however, will be taxed on the activity of a manufacturer as provided under the general excise tax law.

Example 3: "C" is engaged in a scientific contract with the United States. To complete this construction project, certain scientific equipment and supplies which are to become an integral part of the project are imported because they are not available in Hawaii. On the basis of the fact that the imported properties are to become an integral part of the project, no use tax shall be levied or collected on the equipment and supplies imported by "C".

Example 4: Assume the same facts in Example 3 except that "C" is engaged in an operation and maintenance scientific contract with the United States and imports supplies which are to be entirely consumed during the performance of the service contract. On the basis of the fact that the imported supplies are to be entirely consumed in the performance of the contract, no use tax shall be levied or collected on the supplies imported by "C".

Example 5: If "A" and "B" in Examples 1 and 2 were also engaged in selling their merchandise and products at the retail level, use tax at the rate of one-half of one per cent would apply on the imports and purchases (for resale at retail) plus four per cent general excise tax on their subsequent sale at the retail level.

If "C" in Example 3 is involved in other construction projects which do not meet the provisions of section 237-26, HRS, "C" would be subject to the use tax at the rate of one-half of one per cent on the landed value of the tangible personal property imported and incorporated into such nonscientific projects.

If "C" in Example 4 is involved in other operation and maintenance contracts which do not meet the provisions of section 237-26, HRS, "C" would be subject to the use tax at the rate of four per cent on the landed value of the supplies imported for use in such nonscientific contracts.

Example 6: Service business. A tire recapper, "D", who recaps tires belonging to other persons is subject to the use tax at the rate of four per cent in respect of tangible personal property (that is consumed in performance of a service) which: (1) "D" imports and incorporates into such tires; or (2) is transferred to "D" by another person who is not taxable under the general excise tax law in respect of such transfer and which is incorporated into such tires.

Example 7: Manufacturer. A tire recapper, "E", who recaps tires for "E's" own stock for resale is not subject to the use tax in respect of tangible personal property which: (1) "E" imports or acquires and incorporates into such tires; or (2) is transferred to "E" by another person who is not taxable under the general excise tax law in

respect of such transfer and which is incorporated into such tires.

- (g) Basis of Property.
- (1) Purchase price or landed value. Except as provided in paragraph (2), for purposes of section 238-2, HRS, and these rules, the basis of property shall be the purchase price of the tangible personal property if the purchase and sale are consummated in Hawaii or landed value of the tangible personal property if the purchase and sale are consummated outside of Hawaii or if there is no purchase price applicable thereto.
- (2) Deduction for trade-in; depreciation, etc. The time of accrual of the tax in the case of an automobile imported into the State for use shall be at the time the automobile comes to rest in the State and ceases its character as an article in interstate commerce. The landed value for purposes of the use tax basis shall be the landed cost in the State. Such landed cost shall consist of invoice price plus freight, insurance, custom duty, and any other charges incident to landing the motor vehicle in the State, less: (1) trade-in allowance for old car; (2) any charges for license plates outside Hawaii; and (3) a depreciation allowance of ten per cent for normal use outside Hawaii, but this rate may be adjusted depending upon the mileage and condition of the car. The landed value of the motor vehicle shall not include any retail sales tax paid to another state or local government.
- (A) When the motor vehicle has been used prior to bringing it into the State, the landed value for purposes of the use tax basis may be reduced by applying a

depreciation allowance for normal use of the motor vehicle outside of the State. The depreciation allowed depends on the mileage and condition of the motor vehicle. No depreciation is allowed for a motor vehicle brought in to the State within 90 days of its date of purchase. The 90 day period shall not include any shipping time or any time during which a motor vehicle was placed in storage prior to its import into the State.

- (B) For purposes of depreciation, the calculation of the landed value of a motor vehicle used prior to its importation into the State also may include the cost of any repairs or replacement parts added to the motor vehicle to maintain or increase its value during the taxpayer's use of the motor vehicle prior to shipping the motor vehicle into the State. The department of taxation may require an explanation and supporting information for any depreciation reduction of the landed value of a motor vehicle. Taxpayers who believe a depreciation allowance is warranted may use the depreciation schedule printed on the back of the Use Tax Return (Form G-26).
- (C) Section 238-3(h), HRS, allows a credit against the Hawaii use tax for the combined amount of sales or use taxes imposed by and paid to another state (or any subdivision thereof) on tangible personal property before it is imported into the State. Accordingly, a taxpayer may receive a credit up to the amount of Hawaii use tax due (4 percent of the landed value of the motor vehicle) for

any sales or use taxes paid by the taxpayer to another state upon the purchase or use of the motor vehicle. The calculation of the credit shall not include any other taxes paid to other states, such as taxes on manufacturing, license fees, or transfer taxes. The amount of credit also shall not exceed the amount of use tax imposed by the State of Hawaii on such tangible personal property. To substantiate the claim for the credit allowance, the department of taxation may require copies of receipts or vouchers indicating the payment of the sales or use taxes to another state.

- (3) Temporary use. Temporary use of property shall not include any property located in or in use within the State for a period exceeding 365 days.
- (4) Labor charges. Labor charges for the repair or reconditioning of tangible personal property shall be included in the purchase price or landed value of the tangible personal property for purposes of determining the use tax basis.
- (5) Although the sales transaction may be based outside of Hawaii, which is merely a method or means of determining who is to pay the freight from that particular point, primary consideration should be given to the place of delivery of the tangible personal property. Whether the general excise tax or the use tax would be applicable depends upon where the place of delivery of the tangible personal property is located and whether the seller has nexus.
- (6) Application of the rules contained in paragraphs (1) and (5) may be illustrated by

the following examples:

Example 1: A contract is executed in Hawaii by a local consumer and a dealer doing business in Hawaii with the place of delivery in San Francisco and the purchaser arranging for the shipment of the merchandise into Hawaii directly with a common carrier. The use tax of four per cent is applicable. Because the sale is consummated outside of Hawaii, the tax shall be based on the landed value of the merchandise; such value shall include the freight, insurance and handling charges and the seller is required to collect such taxes as provided by section 238-6, HRS, and §18-238-6.

Example 2: A local wholesaler purchases machinery through a dealer doing business in Hawaii. Although the transaction is F.O.B. San Francisco (the purchaser ultimately paying the freight), the actual place of delivery of the merchandise is in Honolulu. Because the dealer is doing business in Hawaii and the sale is consummated in Hawaii, the use tax is not applicable. However, the general excise tax is applicable to the dealer and the gross receipts of the dealer should include the freight, insurance and handling charges.

(h) Deduction and Credit Procedures.

(1) General Rule.

(A) Section 238-2(1), HRS, provides that if a licensed wholesaler, jobber or manufacturer is also engaged in business as a retailer, a use tax of one-half of one per cent shall apply on all imports and purchases, but the director shall

refund to the taxpayer in the manner provided in section 231-23(d), HRS, such amount of tax as the taxpayer shall to the satisfaction of the director, establish to have been paid by the taxpayer on such imports and purchases sold by the taxpayer as a wholesaler or manufacturer.

- (B) Section 238-4, HRS, provides that if a licensed producer who is an importer or purchaser of certain property, as specified in §18-238-4(b), is also engaged in business as a retailer, or in any manner other than as a wholesaler, a use tax of one-half of one per cent shall apply, the same as in the case of a purchaser who is a licensed retailer.
 - (C) In lieu of the refund method provided in section 231-23(d), HRS, a taxpayer described in this paragraph (1) may elect to compute the tax liability for purposes of this chapter under one of the methods described in paragraph (2).
- (2) Permissible methods. The taxpayer may receive a deduction or credit, as the case may be, for imports and purchases from unlicensed sellers that were sold by the taxpayer as a wholesaler, jobber, manufacturer or producer if the taxpayer computes the taxpayer's liability under any of the following methods:
- (A) Method A (Direct Cost Method). Determine the total amount of imports and purchases from unlicensed sellers for the month. Ascertain from your records, category by category, the landed cost of the wholesale and manufacturing sales included in imports and purchases from unlicensed sellers

for the month. Deduct this amount from the total imports and purchases from unlicensed sellers for the month and compute and pay the use tax on the remaining balance. Total amount and deductions must be reflected on monthly tax returns.

Example - A car dealer

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|----|---|------------------------|
| 1. | Total retail sales for the month | \$75,000 |
| 2. | Total wholesale sales for the month | \$15,000 |
| 3. | Total imports and purchases from unlicensed sellers for the month | \$50,000 |
| 4. | Compute cost of automobiles and accessories sold at wholesale during the month which has been included in item 3, item by item, or category by category | |
| | | <u>Cost</u> |
| | Model "X" sedans | \$4,000 |
| | Model "Y" delivery trucks | 6,000 |
| | Model "Z" station wagons | 2,000 |
| | Accessories | <u>1,000</u> |
| | Total cost of wholesale sales to be excluded from the use tax basis | <u>\$13,000</u> |
| 5. | Balance subject to the use tax | <u><u>\$37,000</u></u> |

- (B) Method B (Percentage of wholesale sales to total sales method). Determine the total amount of imports and purchases from unlicensed sellers for the month. Ascertain the percentage of wholesale sales to total sales for the month. Apply the percentage so determined to the total amount of imports and purchases from unlicensed sellers for the month. This amount would be the amount excluded from the use tax base.

Example:

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|----|----------------------------------|----------|
| 1. | Total retail sales for the month | \$85,000 |
|----|----------------------------------|----------|

2.	Total wholesale sales for this month	\$15,000
3.	Total imports and purchases from unlicensed sellers for the month	\$50,000
4.	Percentage of wholesale sales to total sales (\$15,000 ÷ \$100,000)	15%
5.	Total purchases to be excluded from the use tax base (\$50,000 x fifteen per cent)	<u>\$ 7,500</u>
6.	Imports and purchases subject to the use tax for the month (\$50,000 - \$7,500)	<u>\$42,500</u>

It will be permissible for a taxpayer to use the cost of sales to arrive at the percentage ratio for the exclusion of imports or purchases from unlicensed sellers for wholesale sales to compute the use tax base, if the taxpayer has accurate records to support these costs of sales figures. A schedule of these computations must be attached to the monthly tax returns.

- (C) Method C (Gross profit percentage method). Determine the total amount of imports and purchases from unlicensed sellers for the month. Ascertain by gross profit percentage method the cost of wholesale sales included in imports and purchases from unlicensed sellers for the month. Deduct this amount from the total amount of imports and purchases from unlicensed sellers for the month and compute the use tax on the remaining balance.

Example:

1.	Total imports and purchases from unlicensed sellers for the month	\$50,000
2.	Total wholesale sales for the month	\$10,000
	The average gross profit	

	percentage as determined by taxpayer's records	<u>40%</u>
	Gross profit on wholesale sales	<u>\$ 4,000</u>
3.	Cost of wholesale sales for the month (\$ 10,000 - \$4,000)	<u>6,000</u>
4.	Balance subject to use tax for the month	<u>\$44,000</u>

Method C may be utilized only if taxpayer has good records and accounting data to compute proper gross profit percentage.

- (D) Method D (Other methods). The taxpayer may utilize any other method that will reflect the taxpayer's correct tax liability, provided such method is submitted to and approved by the director.
- (3) Special rules for paragraph (2). The taxpayer must select and use the method that will clearly reflect the taxpayer's correct tax liability. Whatever method is used must be used consistently. Permission to change method must have the consent of the director. However, the director may change the method used by the taxpayer anytime the director finds that the method used by the taxpayer does not reflect the taxpayer's correct tax liability. [Eff 2/16/82; am **MAY 26, 1998**]
(Auth: HRS §§231-3(9), 238-16) (Imp: HRS §§238-2, 238-4)

DEPARTMENT OF TAXATION

Amendments to chapter 18-237 and sections 18-238-1 and 18-238-2, Hawaii Administrative Rules, on the Summary page dated April 20, 1998, were adopted on April 20, 1998, following a public hearing held on March 23, 1998, after public notice was given in the Honolulu Advertiser, the Honolulu Star-Bulletin, the Hawaii Tribune-Herald, the Maui News, and the Garden Island News, on February 23, 1998.

These amendments shall take effect ten days after filing with the Office of the Lieutenant Governor.

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RAY K. KAMIKAWA
Director of Taxation

APPROVED:

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BENJAMIN J. CAYETANO
Governor
State of Hawaii

Dated: _____

APPROVED AS TO FORM:

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Deputy Attorney General

MAY 15, 1998

Filed