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DEPARTMENT OF TAXATION ANNOUNCEMENT NO. 2009-34

RE: Imposition of general excise tax and use tax with regard to imported services or contracting; "whipsaw" assessments

A "whipsaw" occurs when the Department is forced to treat both sides of a transaction consistently where the facts or application of law to those facts are in dispute, and assess only one of two taxpayers based on one view of the facts or law, and allow the statute of limitations on assessment against the other taxpayer to expire before the Department can change its position to conform to a judicial ruling against it on its initial position. To prevent such a whipsaw effect, the department must issue assessments to both taxpayers on inconsistent theories to toll the statute of limitations until the matter is resolved by the courts. However, the Department intends to collect 100% of the proper tax only once, whether it is all from one of the taxpayers or a combination of taxpayers.

The Department has become aware of situations where two or more persons involved in a sale of services or contracting are each claiming that the other is responsible for paying the tax on the services or contracting imported into Hawaii, the tax in question being the general excise tax or its companion tax, the use tax. The "whipsaw" in this context may occur as a result of competing legal theories or disagreement as to the facts and circumstances surrounding the transaction.

With regard to competing legal theories, Tax Information Release 2009-02, issued June 15, 2009, states the Department's position that the proper test for sourcing a sale of services or contracting is the "used or consumed" test, as opposed to an alternative test based upon the "place of performance." *See* Acts 70 and 71, 1999 Session Laws of Hawaii; and Haw. Rev. Stat. § 237-8.6 and Haw. Admin. Rules §§ 18-237-8.6-01, et seq. Where an out-of-state person selling services or contracting to an in-state person takes the position that a "place of performance" test applies for general excise tax sourcing purposes, a whipsaw situation may arise, and the Department may assess the in-state persons purchasing the services or contracting for use tax even though the Department is pursuing the out-of-state service provider for the general excise tax. Even if all persons agree to the "used or consumed" sourcing test, if the persons disagree about the facts and circumstances surrounding the transaction, a whipsaw situation may arise. Although only one sourcing test or one characterization of the facts should logically succeed, if the Department does not assess both persons for the full amount of tax owed, for jurisdictional or procedural reasons, first one and then the other taxpayer may prevail against the Department, thereby denying the Department the ability to collect the full amount of

tax owed as a result of the sale (whether it be general excise tax, use tax, or a combination of both).

Example

Taxpayer A performs a service for Taxpayer B in return for $1,000, resulting in a total excise tax (either general excise tax and/or use tax) and county surcharge assessment of $45. The place of performance of the service is 30% in Hawaii and 70% outside of Hawaii. However, Taxpayer B uses and consumes all of the service in Hawaii. Both Taxpayer A and Taxpayer B have nexus with Hawaii.

If Taxpayer A were to take the position that place of performance is the method for sourcing gross receipts for purposes of Hawaii's general excise tax, then Taxpayer A would report 70% of the receipts outside of Hawaii, leaving Taxpayer A to report and pay general excise tax on 30% of the $1,000, which would be $13.50 in Oahu. If the place of performance test applied to Taxpayer A, then Taxpayer B would be liable for use tax on the 70% sourced outside of Hawaii for general excise tax purposes, as imported services, which would be $31.50. Thus, Taxpayer A and Taxpayer B would collectively pay $45 (*i.e.*, $13.50 + $31.50).

However, if the proper sourcing standard were the used and consumed test (which is the Department's position), then it would be Taxpayer A who would owe general excise tax on 100% of the $1,000, or $45, because all of the services were used and consumed in Hawaii and Taxpayer B would owe no use tax.

Because of the competing sourcing theories (*i.e.*, place of performance or where used or consumed), transactions such as the one in this example are highly likely to result in litigation. Until a court resolves which test, the one based on place of performance or the one based on use and consumption, is the proper standard for general excise sourcing purposes, assessing only one of the taxpayers in a manner consistent with only one of the two possible legal theories could lead to a situation where the entire tax is not collected. If a court concluded that the sourcing standard should be the place of performance test, then an assessment of only Taxpayer A for general excise tax could lead to less than 100% of the proper tax being collected. If a court decision based on the place of performance test was affirmed, this means that the Department should have also assessed Taxpayer B for use tax. If the statute of limitations to assess Taxpayer B for the use tax had expired during the time that the court was resolving Taxpayer A's tax liability, then the Department would not be permitted to assess Taxpayer B, and the entire amount of proper tax would not be collected on the transaction even though it was clear from the start that tax was due on $1,000 transaction, whether it is all from Taxpayer A or a combination of Taxpayer A and Taxpayer B.

Whipsaw assessments have long been accepted with regard to the administration of the federal income tax, as affirmed in many federal court cases. *See e.g.*, *Goodall's Estate v.*

Commissioner, 391 F.2d 775 (8th Cir. 1968); *Wiles v. Commissioner*, 499 F.2d 255 (10th Cir. 1974); *Centel Communications Co. v. Commissioner*, 920 F.2d 1335 (7th Cir. 1990); *Bouterie v. Commissioner*, 36 F.3d 1361 (5th Cir. 1994); *Fayeghi v. Commissioner*, 211 F.3d 504 (9th Cir. 2000); *Preston v. Commissioner*, 209 F.3d 1281 (11th Cir. 2000); *In re Indian Motocycle Co., Inc.*, 452 F.3d 25 (1st Cir. 2006). As the United States Court of Appeals for the Eighth Circuit noted in 1968 in *Goodall's Estate*:

> These are, after all, tax cases. Substantial sums are involved. The Commissioner is charged with the protection of the revenues. While these factors might be viewed as pragmatic, it would be unseemly, we feel, to force the Commissioner, in the performance of his administrative duties, to make an awesome choice of this kind at his peril. Taxes are not a game. Of course, the Commissioner, and the government itself, in this court is no more and no less than just another litigant. But we are aware of every person's tax responsibilities and we are not inclined to let the realization of revenues stand or fall on so technical a base as impeccable consistency. Consistency is desirable but its virtue has limits. Good faith inconsistency buttressed by acceptable argument, when considered in the framework of the Commissioner's responsibilities, cannot be regarded as an offense which provides a bar to bona fide tax litigation.

Where the facts or application of law to those facts are in dispute with regard to services or contracting, the Department intends to assess all persons party to the transaction in order to protect the statute of limitations until the dispute is resolved by the courts. However, the Department intends to collect 100% of the proper tax only once, whether it is all from one of the taxpayers or a combination of taxpayers.

For more information regarding this Announcement, please contact the Technical Section at 808-587-1577.

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