HAWAII ADMINISTRATIVE RULES

TITLE 18

DEPARTMENT OF TAXATION

CHAPTER 235
INCOME TAX LAW

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This is an unofficial compilation of the Hawaii Administrative Rules.

Historical Note: Chapter 235 of Title 18, Administrative Rules, is based substantially upon Regulation 79-1(N) of the Department of Taxation [Eff 1/1/78; R 2/16/82], Regulation 79-2(N) of the Department

of Taxation [Eff 1/7/78; R 2/16/82], Regulation 79-3(N) of the Department of Taxation [Eff 7/1/80; R 2/16/82].

Note: The rules implement the statute and may not reflect recent changes in the statute.

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SUBCHAPTER 1

GENERAL PROVISIONS

HRS §235-1 **§18-235-1** Amended and renumbered.

HRS §235-1 **§18-235-1.01 Resident/Nonresident, defined.** "Resident" means:

(1) Every individual domiciled in Hawaii; and

(2) Every other individual whether domiciled in Hawaii or not, who resides in Hawaii for other than a temporary or transitory purpose.

"Nonresident" means every individual other than a resident. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.01 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.02 Residency, generally.** (a) A resident is subject to the net income tax imposed by chapter 235, HRS, on income from all sources, both in the state and outside the state, as set forth in section 18-235-4-02, HAR. A nonresident, however, is subject to the net income tax imposed by chapter 235, HRS, only on income from sources within Hawaii, as set forth in section 18-235-4-03, HAR.

(b) The status of an individual as a resident or nonresident is determined by all of the factual circumstances. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.02 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.03 Establishing residency by domicile.** (a) An individual who is domiciled in Hawaii is considered a resident.

(1) Domicile is the place of the individual's true, fixed, permanent home.

(2) The domicile is the principal establishment to which the individual has the intention of returning whenever the individual is absent.

(3) An individual can have several residences or dwelling places in which he or she resides, but can have only one domicile, or permanent residence to which he or she intends to return.

(b) An individual's domicile may change where there is a concurrence of:

(1) An abandonment of the old domicile with a specific intent to abandon the old domicile;

(2) An intent to acquire a specific new domicile; and

(3) An actual physical presence in the new domicile.

(c) The burden of proof as to a change of domicile is upon the individual asserting that a change in domicile has taken place. The individual must establish a change of domicile by clear and convincing evidence.

(d) An individual can acquire a domicile by birth, choice, or operation of law, as set forth in sections 18-235-1-04, 18-235-1-05, and 18-235-1-06, HAR, respectively. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.03 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.04 Domicile by birth.** (a) "Domicile by birth" is acquired by every individual at birth and continues until replaced by the acquisition of another domicile. A child is given the domicile of the child's parents at the time of the child's birth. A domicile by birth, however, may not be the same place where the child is born. If the parents' domicile is other than where the child is born, the parents' domicile is the domicile of the child.

(b) If a child is born to parents who have different places of domicile, the child's domicile will generally be the same as the domicile of the parent who is able to claim the child as a dependent.

Example 1: A, a domiciliary resident of Hawaii, married a domiciliary resident of Oregon. Their first child was born in Hawaii and their second child was born in Texas. A files a separate Hawaii resident income tax return. A claims both children as dependents.

Conclusion: Both children are deemed to be domiciliary residents of Hawaii because A, a domiciliary resident of Hawaii, claims both children as dependents. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.04 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.05 Domicile by choice.** (a) "Domicile by choice" is a domicile chosen by an individual to replace the individual's former domicile. An individual can acquire a domicile by choice when:

(1) The individual is no longer eligible to be claimed as a dependent on another person's federal or Hawaii income tax return; and

(2) The individual has reached the legal age of majority in Hawaii.

The individual may then voluntarily establish the place of the individual's domicile wherever he or she may be. In doing so, however, the individual must meet all the requirements of law for the purpose of establishing a new domicile.

Example 1: B was born in Honolulu to domiciliary residents of Hawaii, attended grade school and high school in Hawaii, then lived on the mainland while attending college for four years. During college, B voted in Hawaii by absentee ballot, maintained a savings account in Hawaii, and maintained his membership in the Honolulu Jaycees. Upon B's graduation from college, B decided to make his home in California and B did, in fact, establish a permanent domicile there. B bought a home, voted in California elections, became active in community affairs, and joined various school and business clubs. After working for several years in California, B departed for a Trust Territory on a 2-year contract where B is presently working for a mainland contractor.

Conclusion: B is deemed to be a domiciliary resident of Hawaii at birth. During the four-year period that B lived on the mainland while attending college, B remained a resident of Hawaii. A Hawaii domiciliary resident who attends school outside of Hawaii remains a Hawaii domiciliary resident unless the individual establishes a domicile outside of Hawaii. B abandoned B's domicile in Hawaii when a permanent domicile was established in California. B is now deemed to be a nonresident of Hawaii.

Example 2: C, a resident of Hawaii, attended college on the mainland. While on the mainland, C traveled to a foreign country to perform missionary work. Upon returning to the mainland, C completed college. C then returned to Hawaii and got married. C secured employment with an agency of the United States government and moved to Japan to work. In C's applications for employment, transportation agreement, passport, and other formal documents and papers pertaining to employment in Japan, C stated that C's legal residence was in Honolulu, Hawaii. C continued to make deposits to C's bank in Hawaii. C also opened a bank account in Japan and made some investments through Japanese companies. It was not C's intention to make Japan C's fixed and permanent home. Accordingly, C made no effort to establish a new domicile in Japan nor to abandon the old domicile in Hawaii.

Conclusion: C is deemed to be a resident of Hawaii while attending college on the mainland, while performing missionary work in a foreign country, and while working in Japan. A Hawaii domiciliary resident who attends school outside of Hawaii remains a Hawaii domiciliary resident unless the individual establishes domicile outside of Hawaii. It is apparent that C did not establish the foreign country or Japan as a permanent home. C was in the foreign country only for the purpose of performing missionary work and is in Japan only for the purpose of employment and has not acquired a new domicile. Nor has C abandoned the domicile in Hawaii. Under the facts presented, the same answer would apply if C was working in Korea, Germany, on the mainland United States, or elsewhere.

Example 3: D, a resident of Hawaii, contracts to work for a company in Japan. The contract is a renewable three-year contract. D is married and D's spouse and children accompany D to Japan. D rents a home and opens bank accounts in Japan. D's children attend local schools in Japan. D does not own any property in Hawaii and has not voted in Hawaii since moving to Japan. At the end of the three-year contract, D renews D's contract with the company in Japan for another three years. At the renewal period, D's applications for employment, transportation agreement, passport, and other formal documents and papers pertaining to employment in Japan stated that D's legal residence was in Honolulu, Hawaii. It was not D's intention to make Japan D's permanent and indefinite home. Accordingly, D made no effort to establish a new domicile in Japan nor to abandon the old domicile in Hawaii.

Conclusion: D is deemed to be a resident of Hawaii during the period that D worked in Japan. It is apparent that D did not establish Japan as a permanent home. D is there only for the purpose of employment and has not acquired a new domicile. Nor has D abandoned the domicile in Hawaii. Under the facts presented, the same answer would apply if D was working in Korea, Germany, on the mainland United States, or elsewhere. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.05 8/28/98] (Auth: HRS §§ 231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.06 Domicile by operation of law.** (a) "Domicile by operation of law" is assigned or attributed to an individual independently of the individual's residence or intention. In the usual case, domicile by operation of law is applied to those individuals, who, because of certain disabilities, are unable to acquire a domicile by choice. These would include such individuals as minor children and incompetents.

(b) If a child becomes a dependent, for tax purposes, of someone with a different domicile, the child's domicile will generally be the same as the domicile of the individual who is able to claim the child as a dependent.

Example 1: E, a Hawaii domiciliary resident, has one child from an earlier marriage to another Hawaii domiciliary resident. E subsequently marries F, a domiciliary resident of Utah. F provides all of the support for both E and E's child (F's stepchild). F claims the child as a dependent.

Conclusion: The child is deemed to be a nonresident of Hawaii because F, a domiciliary resident of Utah, claims the child as a dependent. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.06 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.07 Establishing residency by residing in the State.** (a) An individual who is not domiciled in Hawaii may acquire the status of a resident by virtue of being physically present in Hawaii for other than a temporary or transitory purpose.

(b) Whether or not the purpose for which an individual is in Hawaii will be considered temporary or transitory in character will depend upon the facts and circumstances of each particular case.

(c) An individual will be deemed a nonresident of Hawaii if he or she is in Hawaii for a temporary or transitory purpose, including the following:

(1) The individual is simply passing through Hawaii to another state or country;
(2) The individual is in Hawaii for a brief rest or vacation;
(3) The individual is in Hawaii for health reasons and is receiving medical treatment or recuperating from an illness; and
(4) The individual's presence in Hawaii is required for a short period to complete a particular transaction or perform a particular contract.

(d) An individual will be deemed a resident of Hawaii if they are in Hawaii for other than a temporary or transitory purpose, including the following:

(1) The individual is in Hawaii for business purposes which will require a long or indefinite period to accomplish;
(2) The individual is employed in a position that may last permanently or indefinitely; and
(3) The individual has retired and moved to Hawaii with no definite intention of leaving.

(e) If an individual has been in Hawaii more than 200 days of the taxable year in the aggregate (not consecutive), the individual is presumed to have been a resident of Hawaii from the time of the individual's arrival. The presumption may be overcome if the individual rebuts the presumption with evidence satisfactory to the Department of Taxation that the individual maintains a permanent place of abode outside of Hawaii and is in Hawaii for a temporary or transitory purpose.

(f) Since each state's definition of "resident" may be different, it is possible for an individual to be considered a resident of more than one state.

Example 1: G, a civil engineer, is domiciled in New York where G owns a house in which G's family lives. G votes in New York, maintains a bank account there and returns to his home in New York whenever possible. G is employed by a company as supervising engineer of its projects. In 1995, the company enters into a contract for construction work in Hawaii which will require G to spend 18 months in Hawaii. G comes to Hawaii in 1995 and spends almost the entire year living in a rented apartment. G's spouse and family remain in New York except for a summer visit to Hawaii. Upon completion of the project, G will return to New York to await another assignment.

Conclusion: Since G has been in Hawaii more than 200 days of the taxable year in the aggregate, G is presumed to have been a resident of Hawaii from the time of G's arrival. G, however, rebuts the presumption under the above circumstances showing that G maintains a permanent place of abode outside Hawaii and is in Hawaii for a temporary or transitory purpose. Accordingly, G is deemed to be a nonresident of Hawaii.

Example 2: H, a civil engineer, is domiciled in California. H is employed by a company in California. In 1996, H was transferred to Hawaii with the same company. H did not request the transfer to Hawaii. The transfer was made for the convenience of H's employer and H was required to work indefinitely in Hawaii or lose H's position with the company. H's spouse and children accompanied H to Hawaii. H has always considered California to be H's permanent home and always intended to return to California. No affirmative steps were taken either to abandon the domicile in California or to establish a permanent domicile in Hawaii.

Conclusion: H is deemed to be a resident of Hawaii. Although H is domiciled in California, H is in Hawaii for other than a temporary or transitory purpose since H's employment in Hawaii is for an indefinite period.

Example 3: J, is an attorney employed by a New York law firm, and domiciled in the State of New York, where she owned and occupied an apartment. J, however, suffers from a respiratory disease and was advised by a physician that warm, humid air would be beneficial. As a result, J rented out her apartment and moved to Hawaii. J bought an apartment in Hawaii, opened and maintained a bank account, and joined a church in Hawaii. J, however, made it known to friends and family that she had not quit her job at the law firm and that she planned to return to New York to resume her practice when her health would permit. J otherwise made it known that she was in Hawaii for health purposes only.

Conclusion: J is deemed to be a nonresident of Hawaii. A change of residence for health reasons only will not result in a change of domicile unless it is accompanied by a definite intention to abandon the former domicile and acquire a new one. In this case, J made it clear that she was in Hawaii for health reasons only and intended to return to New York when her health would permit. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.07 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.08 Residence status, factors considered.** The question of domicile and residency is one of law and fact. A change of domicile will depend upon the acts and declarations of the individual concerned to ascertain whether or not the individual possessed the required intention which the law requires to effect a change of domicile. Similarly, the status of an individual as a resident or nonresident is determined by all the factual circumstances; no single factor is controlling. Some of the relevant factors for determining domicile and residency are:

(1) The length of time spent in Hawaii;
(2) Leasing, buying, negotiating for or building a home;
(3) Ownership and location of a motor vehicle;
(4) Place of issuance of a license to drive a motor vehicle;
(5) Location of auto, boat, and airplane registrations;
(6) Place of marriage;
(7) Where the residence of one spouse is in issue, the place of residence of the other spouse;
(8) Residence of the family of the individual;
(9) Location of schools attended by the individual's children;
(10) Address at which bank statements, bills, financial data and correspondence concerning other family business is primarily received;
(11) Location of club, church, and social memberships;
(12) Place where the taxpayer is registered to vote and exercise of said privilege;
(13) Location of business interests, profession, or employment;
(14) Physical location of safe-deposit boxes used for family records and valuables;
(15) Contributions to local charities;
(16) Declarations regarding residence made to public authorities, friends, relatives or employers, or in documents such as deeds, leases, mortgages, contracts, and insurance policies;
(17) Proposed location of burial or acquisition of burial plot for the individual or members of the individual's family; and
(18) Location where the individual's will is admitted to probate. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.08 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.09 Individual's presence or absence in compliance with military or naval orders, while engaged in aviation or navigation, or while a student.** (a) An individual's status as a resident or nonresident shall not change solely because of the individual's presence or absence in compliance with military or naval orders of the United States, while engaged in aviation or navigation, or while a student at any institution of learning.

(b) A nonresident individual who is in Hawaii while on military duty, while engaged in aviation or navigation, or while attending school is not a Hawaii resident unless the individual establishes domicile in Hawaii.

(c) Similarly, a Hawaii domiciliary resident who resides outside of Hawaii while on military duty, while engaged in aviation or navigation, or while attending school, remains a Hawaii domiciliary resident unless the individual establishes domicile in another state or a foreign country.

(d) Spouses of nonresident service members, crew members, or students who come to Hawaii will remain nonresidents of Hawaii if their principal reason for moving to Hawaii was to accompany their spouse, and if it is their intention to leave Hawaii when their spouse is transferred, discharged, or graduates.

Example 1: J is employed by an interstate airline as a crew member. J has no spouse or children. J votes in Pennsylvania, where J was born and raised, and which J regards as J's domicile. J lays over in Hawaii between flights and for rest periods, using hotel accommodations. In 1994, J is physically present in Hawaii for more than 200 days during the calendar year.

Conclusion: J is deemed to be a nonresident of Hawaii. A person shall not be deemed to have gained a residence in Hawaii because of his or her presence in Hawaii while engaged in aviation.

Example 2: Mr. and Mrs. K are residents of Michigan. Their daughter, L, also is a Michigan resident. L came to Hawaii to attend college and took some action to become a permanent resident of Hawaii. L closed her bank account in Michigan and opened a bank account in Hawaii. L also became a member of a local church in Hawaii. Although L works part-time, more than half her support comes from her parents. Her parents claim her as a dependent.

Conclusion: L is deemed to be a nonresident of Hawaii. Although L took some action to become a permanent resident of Hawaii, her principal reason for being in Hawaii is to attend college. A person shall not be deemed to have gained a residence in Hawaii because of his or her presence in Hawaii while attending school. A nonresident individual who is in Hawaii while attending school will not be deemed to be a resident of Hawaii unless the individual establishes domicile in Hawaii. L cannot establish a new domicile in Hawaii because L is claimed as a dependent on her parents' federal income tax return.

Example 3: M, who was born and educated in Hawaii, enlisted in the military and was stationed outside of Hawaii. M intends to return to Hawaii after discharge from the military. Accordingly, M made no effort to establish a new domicile outside of Hawaii nor to abandon M's domicile in Hawaii.

Conclusion: M is deemed to be a resident of Hawaii regardless of the length of M's absence from Hawaii while on military duty. A Hawaii domiciliary resident who resides outside of Hawaii while on military duty remains a Hawaii resident unless the individual establishes domicile in another state or a foreign country. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.09 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-1)

HRS §235-1 **§18-235-1.10 Aliens.** (a) "Alien" means an individual who is not a United States citizen.

(b) An alien is a resident of Hawaii if the alien has permanent resident alien status (green card) and is domiciled in Hawaii, or resides in Hawaii for other than a temporary or transitory purpose. Thus, like all other individuals, the status of an alien as a resident or nonresident for Hawaii income tax purposes is determined by all of the factual circumstances.

(c) Hawaii has not adopted the federal provisions of Internal Revenue Code (IRC) section 7701(b)(with respect to the definition of resident alien and nonresident alien), and therefore, section 7701(b) does not control for Hawaii income tax purposes. In addition, tax treaties between the United States and foreign countries do not apply to sub-nation states' taxing authority and therefore do not control for Hawaii income tax purposes.

(d) In certain situations, a taxpayer may be considered a nonresident alien for federal income tax purposes and a resident for Hawaii income tax purposes. In these situations, the special rules applicable to individuals who are considered nonresident aliens for federal income tax purposes will apply when the individual files a Hawaii resident income tax return.

Example 1: N, a Hawaii resident, married O, a citizen of Australia, while both were attending college in Hawaii. Upon their graduation from college, they both found employment in Hawaii. After their marriage, O filed the required documents and became a permanent resident alien.

Conclusion: O is deemed to be a resident of Hawaii. O is domiciled in Hawaii and became a permanent resident alien upon her marriage to N.

Example 2: P is a Japanese national who is domiciled in Japan. In 1995, P moved to Hawaii to manage a Japanese company's U.S. business operations. P was admitted by the United States Immigration and Naturalization Service as a nonimmigrant alien. P's authorized stay can be extended periodically. During 1995, P was physically present in Hawaii for more than 200 days during the taxable year.

Conclusion: P is deemed to be a resident of Hawaii. Although P is in Hawaii as a nonimmigrant alien, and is domiciled in Japan, P is in Hawaii for other than a temporary or transitory purpose.

Example 3: Q accepted a tenure track position at the University of Hawaii, and arrived to begin employment on August 1, 1996. Although Q entered the United States on a nonimmigrant alien visa, Q intends to remain in the United States as a permanent resident alien and pursue tenure at the University of Hawaii.

Conclusion: Although Q was not in Hawaii for more than 200 days in 1996, Q is in Hawaii for other than a temporary or transitory purpose. Therefore, Q should file as a part-year resident for tax year 1996 even though the 200 day test of the presumption of residency is not met.

Example 4: Mr. and Mrs. R and their son are citizens of Brazil and are in Hawaii on J visas. Mr. R is a teacher and does not meet the substantial presence test under IRC section 7701(b)(3) and is, therefore, a nonresident alien for federal income tax purposes. Mr. R files a federal Form 1040-NR on which his filing status is required to be married filing a separate return. IRC section 6013(a)(1) does not allow the filing of a joint return if either spouse was a nonresident alien at any time during the taxable year. Mrs. R also works part-time in Hawaii. Mr. and Mrs. R and their son were in Hawaii for more than 200 days in 1996 and will be filing as Hawaii residents. Can Mr. and Mrs. R file a joint Hawaii resident tax return?

Conclusion: Section 235-93, HRS, provides that a husband and wife, having that status for purposes of the IRC and entitled to make a joint federal return for the taxable year, may make a single return jointly of taxes under this chapter for the taxable year. Hawaii has adopted the provisions of IRC section 6013(a)(1) through section 18-235- 93(a)(2), HAR. IRC section 6013(a)(1) provides that no joint return shall be made if either the husband or the wife at any time during the taxable year is a nonresident alien. Accordingly, Mr. and Mrs. R cannot file a joint Hawaii tax return. Mr. and Mrs. R must each file separate Hawaii resident tax returns.

Example 5: The facts are the same as stated in Example 4. Can Mr. R claim his son as his dependent on his Hawaii resident tax return?

Conclusion: Section 235-54, HRS, provides that the number of personal exemptions an individual may claim is in part determined by ascertaining the number of personal exemptions that the individual may lawfully claim under IRC section 151. IRC section 873(b)(3), limits a nonresident alien individual to claim, under IRC section 151, a single deduction for personal exemption unless the taxpayer is a resident of a contiguous country or a national of the United States. IRC section 152(b)(3) further states that the term "dependent," for purposes of determining personal exemptions under IRC section 151, does not include any individual who is not a citizen or national of the United States unless such individual is a resident of the United States or country contiguous to the United States. For federal income tax purposes, Mr. R cannot claim his son as a dependent since his son is not a U.S. citizen, U.S. national, resident alien or resident of a country contiguous to the United States. Accordingly, Mr. R cannot claim his son as a dependent on his Hawaii resident tax return.

Example 6: The facts are the same as stated in Example 4. Can Mr. R claim the standard deduction on his Hawaii resident tax return.

Conclusion: IRC section 63(c)(6), which Hawaii adopts through section 235-2.4(a), HRS, provides that a nonresident alien individual cannot claim the standard deduction. Accordingly, Mr. R cannot claim the standard deduction on his Hawaii resident tax return. Mr. R must itemize any allowable deductions.

Example 7: Mr. and Mrs. S are in Hawaii on H visas. Mr. S is a college professor. Mr. S meets the federal substantial presence test but files a federal Form 1040-NR to claim the treaty benefits which exclude his wages as a professor from federal taxation for two years. Mr. and Mrs. S were in Hawaii for more than 200 days in 1996 and will be filing as Hawaii residents. Will the treaty also exclude Mr. S's wages from Hawaii taxation?

Conclusion: The provisions of income tax treaties are between the United States and the foreign country. Income tax treaties are designed to protect taxpayers from double and discriminating taxation by either treaty country, and normally do not preempt state tax laws. Accordingly, the treaty has no effect on Hawaii income tax law and Mr. S's wages as a professor are subject to Hawaii income tax. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.10 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-2.4, 235-54, 235-93)

HRS §235-1 **§18-235-1.11 "Person totally disabled", defined.** (a) "Person totally disabled" means:

(1) A person who is totally and permanently disabled, either physically or mentally; and

(2) Is unable to engage in any substantial gainful business or occupation because of that disability.

(b) Whether a person is totally and permanently disabled and whether the disability results in the person's inability to engage in any substantial gainful business or occupation is determined by reference to all the factual circumstances. Among the factors considered are:

(1) The nature and severity of the disability;

(2) The person's education, training, and work experience; and

(3) Whether social security benefits have been granted or denied. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.11 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-1, 237-17, 237-24(13))

HRS §235-1 **§18-235-1.12 "Person totally disabled", certification of.** (a) The disability of a person claiming to be totally disabled must be certified in a three-step process:

(1) There must be a medical determination that the person is totally disabled, either physically or mentally;

(2) The disability must be permanent; and

(3) There must be a determination that the permanent and total disability results in the person's inability to engage in any substantial gainful business or occupation.

(b) The disability shall be certified by:

(1) A physician licensed under chapters 453 or 460, HRS, or both;

(2) A qualified out-of-state physician who is currently licensed to practice in the state in which the physician resides; or

(3) A commissioned medical officer with the United States Army, Navy, Marine Corps, or Public Health Service, engaged in the discharge of one's official duty.

(c) Certification shall be on forms prescribed by the department of taxation. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.12 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-1, 237-17, 237- 24(13))

HRS §235-1 **§18-235-1.13 "Permanent disability", defined.** "Permanent disability" means a disability that can be expected to result in death or has lasted or can be expected to last for a continuous period of not less than twelve months. The twelve-month requirement is inapplicable when the disability is determined to be a terminal state or where it does actually result in death. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.13 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-1, 237-17, 237-24(13))

HRS §235-1 **§18-235-1.14 "Substantial gainful business or occupation", defined.** (a) As used in this chapter, "substantial gainful business or occupation" means a business or occupation that is both substantial and gainful. It is substantial if it involves significant physical or mental activity even if the individual works on a part-time basis, does less work, is paid less, or has fewer responsibilities than when the individual worked prior to the disability. The business or occupation is gainful if it is done for monetary consideration or profit.

(b) It shall be presumed that an individual whose earned income is greater than $30,000 for the taxable year is engaged in a substantial gainful business or occupation.

Example 1: Taxpayer retires from employment on disability that is total and permanent. After retirement, Taxpayer accepts another job and Taxpayer's earned income is greater than $30,000 for the taxable year. Taxpayer is engaged in a substantial gainful business or occupation because Taxpayer's earned income is greater than $30,000 for the taxable year.

Example 2: Taxpayer retires as a teacher on disability that is total and permanent. Taxpayer begins babysitting children and selling items. Taxpayer's earned income from these two businesses is greater than $30,000 for the taxable year. Taxpayer is engaged in a substantial gainful business or occupation because Taxpayer's earned income is greater than $30,000 for the taxable year.

(c) In the case of husband and wife filing a return jointly and only one of the spouses is disabled, only the disabled spouse's earned income is measured.

Example 1: A and B file a joint income tax return. Only A is disabled. A's earned income is less than $25,000 for the taxable year. B's earned income is greater than $30,000 for the taxable year. For purposes of determining whether an individual is engaged in a "substantial gainful business or occupation," only the disabled spouse's earned income is measured when a joint tax return is filed. A is not engaged in a substantial gainful business or occupation because A's earned income is less than $30,000 for the taxable year.

(d) For purposes of this section, earned income includes wages, salaries, tips, business interest income, other employment compensation, and net earnings from self-employment for the taxable year. Earned income does not include interest, dividends, capital gains, pensions, or deferred compensation.

Example 1: Taxpayer retires on disability that is total and permanent and receives an insurance settlement. Taxpayer does not engage in any other employment. The insurance settlement is invested and Taxpayer receives $35,000 in interest, dividends, and capital gains during the taxable year. Taxpayer is not engaged in a substantial gainful business or occupation because earned income does not include interest, dividends, and capital gains.

(e) The presumption with respect to the $30,000 earned income limitation set forth in subsection (b) is applicable to all totally and permanently disabled persons, including the following:

(1) A person who lost or is born without both feet at or before the ankle;
(2) A person who lost or is born without both hands at or above the wrist;
(3) A person who lost or is born without one hand and one foot;
(4) A person who has an injury or defect resulting in permanent and complete paralysis of both legs or both arms or one leg and one arm; or
(5) A person who has an injury or defect resulting in incurable imbecility or mental illness.

Example 1: Taxpayer retires on disability that is total and permanent because Taxpayer loses both feet at the ankles in an accident. After retirement, Taxpayer accepts another job and Taxpayer's earned income from that job is greater than $30,000 for the taxable year. Taxpayer is engaged in a substantial gainful business or occupation because Taxpayer's earned income is greater than $30,000 for the taxable year. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.14 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-1, 237-17, 237-24(13))

HRS §235-1 **§18-235-1.15 Permanent total disability; submission of certification.** (a) An individual claiming the tax benefits under the tax laws shall attach to the individual's income tax return the original certification of permanent total disability.

(b) The individual shall retain a copy of the certification in the individual's records and may continue to claim the exemption by attaching a copy of the original certification to the tax return in subsequent years.

(c) Where the statutory requirements are not met or in appropriate circumstances, the department may request additional information or deny the claim for exemption in the first year or subsequent years. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.15 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-1, 237-17, 237-24(13))

HRS §235-1 **§18-235-1.16 "Resident estate", defined.** "Resident estate" means the same as in section 235-1, HRS. The estate of a decedent who was a resident at the time of death is a resident estate if a Hawaii court appoints a personal representative or administrator to carry on and who does carry on the principal or an ancillary administration of the estate. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.16 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-1)

HRS §235-1 **§18-235-1.17 "Resident trust", defined.** "Resident trust" means the same as in section 235-1, HRS.

(1) If the administration of the trust is carried on wholly in the State the trust shall be deemed a resident trust irrespective of the place of residence of the fiduciary or fiduciaries.
(2) If the sole fiduciary, or all of the fiduciaries if more than one, are residents, domestic corporations, or partnerships formed under Hawaii law, the trust shall be deemed a resident trust irrespective of the place where the trust is administered.
(3) If the administration of the trust is partly carried on in the State, the trust shall be deemed to be a resident trust if one-half or more of the fiduciaries are residents, domestic corporations, or partnerships formed under Hawaii law. [Eff 2/16/82; am 9/3/94; am and ren §18-235-1.17 8/28/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-1)

§18-235-2.1 to 18-235-2.2 (Reserved)

HRS §235-2.3 **§18-235-2.3 Conformance to the federal Internal Revenue Code.** (a) In general.

(1) In order to permit a proper administration of the Hawaii net income tax law which by Act 62, S.L.H. 1979, adopted by reference various provisions of the federal Internal Revenue Code, as amended as of December 31, 1979, the director of taxation finds it desirable to

establish and publish income tax rules and regulations, conforming to the requirements of chapter 91, HRS. When promulgated as required by law, these rules and regulations have the force and effect of law under chapter 235, HRS, and any other chapters which contain provisions relating to chapter 235. The law and regulations must be read together, because the regulations relating to a particular section of the law do not necessarily cover every point in the section.

(2) Scope. These rules and regulations are promulgated to:

(A) Adopt the Federal Tax Regulations relating to subtitle A, Chapters 1 and 6 of the Internal Revenue Code of 1954 as amended as of December 31, 1978, set forth in this regulation.

(B) List the inoperative sections of the Internal Revenue Code. The related federal regulations to these Internal Revenue Code sections shall also be inoperative.

(C) As provided by section 235-2.3 (c) to (m), HRS, certain Internal Revenue Code sections, subsections, parts of subsections, and federal Public Law that do not apply or that are otherwise limited in application also shall apply to the related federal regulations as contained in this regulation.

(3) Adoption of federal tax regulations. The regulations relating to those sections of subtitle A, Chapters 1 and 6, Internal Revenue Code of 1954, as amended as of December 31, 1978, adopted by section 235-2.3, HRS, which are contained in the Federal Tax Regulations 1979 (Title 26, Internal Revenue, 1954 Code of Federal Regulations), with amendments and adoptions to January 1, 1979, and which are not in conflict with provisions contained in chapters 235, 231, or 232, Hawaii Revised Statutes, are hereby adopted by reference and made a part of the rules and regulations of the department of taxation, as they apply to the determination of gross income, adjusted gross income, ordinary income and loss, and taxable income, except insofar as the regulations pertain to provisions of the Internal Revenue Code and federal Public Law, which pursuant to chapter 235, HRS, and this regulation, do not apply or are otherwise limited in application. Provisions in this regulation in conflict with those sections of the Internal Revenue Code, the Federal Regulations or the federal Public Law shall be limited as provided under section 235-2.3(n), HRS.

(b) Inoperative federal tax regulations. The federal regulations relating to the following Internal Revenue Code subchapters, parts of subchapters, sections, subsections, and parts of subsections shall not be operative for the purposes of HRS chapter or this regulation unless otherwise provided. (See section 235-2.3(b), HRS.)

Subchapter	Section of I.R.C.
A	1 to 58
B	78, 103, 116, 120, 122, 151, 169, 241 to 250 (except 248 and 249), 280C
C	367
E	457
F	501 to 528 (except 512 to 515)
G	531 to 565
H	581 to 596
J	642(a), (b), (d), 668
L	801 to 844
M	853
N	861 to 999
O	1055, 1057

P	1201
Q	1301 to 1351
T	1381 to 1388

(c) Zero bracketing. The federal regulations relating to the determinations, provisions, and requirements to zero-bracket amounts in the amendments to the Internal Revenue Code by Public Law 95-30, sections 101 and 102 (with respect to change in tax rates and tax tables to reflect permanent increase in standard deduction and change in definition of taxable income to reflect change in tax rates and tables) shall not be operative. (See section 235-2.3(c), HRS.)

(d) Standard deduction; individuals not eligible for standard deduction and election of standard deduction. (I.R.C. Sections 141, 142, 144). As provided by section 235-2.3(d), HRS, Internal Revenue Code Sections 141, 142, and 144 shall be operative as of June 7, 1957, as amended as of that date. The federal regulations relating to these Internal Revenue Code sections shall be inoperative for this State. The standard deduction as adopted by the State allows individuals to itemize or to elect to take a 10 per cent standard deduction, but not both.

(1) Standard deduction. IRC Section 141, as amended, as of June 7, 1957, provides as follows:
"Sec. 141. Standard deduction. The standard deduction referred to in section 63(b) (defining taxable income in case of individual electing standard deduction) shall be an amount equal to 10 per cent of the adjusted gross income or $1,000, whichever is the lesser, except that in the case of a separate return by a married individual the standard deduction shall not exceed $500."
In the case of a joint return, there is only one adjusted gross income and only one standard deduction. The standard deduction is $1,000 or 10 per cent of the combined adjusted gross income, whichever is the lesser.

Example: If a husband has an income of $15,000 and his spouse has an income of $12,000 for the taxable year for which they file a joint return, and they have no deductions allowable for the purpose of computing adjusted gross income, the adjusted gross income shown by the joint return is the combined income of $27,000, and the standard deduction is $1,000 and not $2,000.

(2) Eligibility.

(A) IRC Section 142, as amended, as of June 7, 1957, provides as follows:
"Sec. 142. Individuals not eligible for standard deduction.

(a) Husband and wife.—The standard deduction shall not be allowed to a husband or wife if the tax of the other spouse is determined under section 1 on the basis of the taxable income computed without regard to the standard deduction.

(b) Certain other taxpayers ineligible.—The standard deduction shall not be allowed in computing the taxable income of—

(1) a nonresident alien individual;

(2) a citizen of the United States entitled to the benefits of section 931 (relating to income from sources within possessions of the United States);

(3) an individual making a return under section 443(a)(1) for a period of less than 12 months on account of a change in his annual accounting method; or

(4) an estate or trust, common trust fund, or partnership."

(B) For the purpose of section 235-2.3(d), HRS, the reference in IRC Section 142(a) to section 1 shall be deemed a reference to section 235-51, HRS. In the case of husband and wife, if the tax of one spouse is determined under section 235-51, HRS, on the basis of the taxable income computed without regard to the standard deduction and, the other spouse may not elect to take the standard deduction. If each spouse files a separate Form N-12 or N-15, both must elect to take the standard deduction or both spouses are denied the standard deduction. If one spouse files Form N-12 or N-15 and does not elect to take the standard deduction, the other spouse may not elect to take the standard deduction and, accordingly, may not compute his tax under the provisions of section 235-53, HRS, or file Form N-13 as his separate return for the taxable year.

Example: If A and his wife B, both residents of Hawaii, have gross income of $16,000 and $3,500, respectively, from wages subject to withholding and A files Form N-12 (long form) and does not elect thereon to take the standard deduction, B may not file Form N-13

(short form) but must file Form N-12, taking thereon only her actual allowable deductions and not the standard deduction. In such case, however, if both elect to take the standard deduction, A must file Form N-12 (since his gross income exceeds the amount provided by section 235-53, HRS) but B may file Form N-13, or in the alternative, she may file Form N-12 and compute the tax by using the optional tax table. Under either alternative, effect is given to the standard deduction.

(3) Election.

(A) IRC Section 144, as amended, as of June 7, 1957, provides as follows:

"Sec. 144. Election of standard deduction.

(a) Method and effect of election.—

(1) If the adjusted gross income shown on the return is $5,000 or more, the standard deduction shall be allowed if the taxpayer so elects in his return, and the Secretary or his delegate shall by regulations prescribe the manner of signifying such election in the return. If the adjusted gross income shown on the return is $5,000 or more, but the correct adjusted gross income is less than $5,000, then an election by the taxpayer under the preceding sentence to take the standard deduction shall be considered as his election to pay the tax imposed by section 3 (relating to tax based on tax table); and his failure to make under the preceding sentence an election to take the standard deduction shall be considered his election not to pay the tax imposed by section 3.

(2) If the adjusted gross income shown on the return is less than $5,000, the standard deduction shall be allowed only if the taxpayer elects in the manner provided in section 4, to pay the tax imposed by section 3. If the adjusted gross income shown on the return is less than $5,000, but the correct adjusted gross income is $5,000 or more, then an election by the taxpayer to pay the tax imposed by section 3 shall be considered as his election to take the standard deduction; and his failure to elect to pay the tax imposed by section 3 shall be considered his election not to take the standard deduction.

(3) If the taxpayer on making his return fails to signify in the manner provided by paragraph (1) or (2), his election to take the standard deduction or to pay the tax imposed by section 3, as the case may be, such failure shall be considered his election not to take the standard deduction.

(b) Change of election. Under regulations prescribed by the Secretary or his delegate, a change of an election for any taxable year to take or not to take, the standard deduction, or to pay, or not to pay, the tax under section 3, may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding, for purposes of section 142(a), to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations:

(1) The spouse makes a change of election with respect to the standard deduction for the taxable year covered in such separate return, consistent with the change of election sought by the taxpayer; and

(2) The taxpayer and his spouse consent in writing to the assessment, within such period as may be agreed on with the Secretary or his delegate, of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law. This subsection shall not apply if the tax liability of the taxpayer's spouse, for the taxable year corresponding (for purposes of section 142(a)) to the taxable year of the taxpayer, has been compromised under section 7122."

(B) For the purpose of section 235-2.3(d), HRS, the reference in IRC section 144, to sections 3, 4, and 7122 shall be deemed references to sections 235-53, 52, and 231-3(10), HRS, respectively.

(C) A taxpayer whose adjusted gross income as shown by his return equals to or exceeds the amount provided under section 235-53, HRS, or who otherwise is ineligible to use the optional tax tables but is eligible for the standard deduction (such as a person entitled to the special exemption under section 235-54(c), HRS, shall be allowed the standard deduction if he elects on such return to take such deduction. Such taxpayer

shall so signify by claiming on his return the ten per cent standard deduction instead of itemizing the non-business deductions allowed in computing taxable income.

(D) A change of election must be made within the period of three years after filing of the return for the taxable year involved, or within three years of the due date prescribed for the filing of said return, whichever is later.

(E) The director cannot allow an overpayment credit after expiration for the period of time prescribed in section 235-111, HRS, which limits both credits and assessments of additional taxes. This period of time is not extended by the making of a change of election.

(e) Employee annuity. (I.R.C. Section 403). Taxation of employee annuity shall be the same except for the amount of premium withheld from the salary of an employee by the Department of Education and the University of Hawaii for the purchase of an annuity contract under Act 40, S.L.H. 1967. This amount is includible as taxable gross income and subject to the withholding tax provisions of this State. Amendments to I.R.C. Section 403 by Public Law 87-370, section 3 were not adopted by this State. (See section 235-2.3(e), HRS.)

(f) Administering pensions, profit sharing, etc. (I.R.C. Section 401 to 415).

(1) The Department of Taxation shall follow the applicable provisions set forth in the federal tax regulations in respect to related provisions of I.R.C. Sections 410 to 415.

(2) Records substantiating (i) all data and information on returns (as defined in I.R.C. Section 6103 (b) required on all forms and reports, (ii) authenticated copies of the federal returns filed relating to pensions, profit sharing, stock bonus and other retirement plans, (iii) assessments made by the Internal Revenue Service, including tax on premature distributions (I.R.C. Section 72(m)(5)) and excise taxes imposed by I.R.C. Sections 4971 to 4975, shall be kept and made available for inspection at the principal place of business of the self-employed individual or the employer maintaining the plan or the plan administrator (defined in I.R.C. Section 414(g)) at all times. (See section 235-2.3(f), HRS).

(g) Unrelated business taxable income. (I.R.C. Sections 512 to 515).

(1) In general. The federal regulations relating to the taxation of unrelated business taxable income shall apply to the State except that in the computation thereof sections 235-3 to 235-5, and 235-7 (except subsection (c)), HRS, shall also apply, and any amount of income or deduction which is excluded in computing the unrelated business taxable income shall not be allowed in determining the net operating loss deduction under section 235-7(d), HRS. Any income from a prepaid legal service plan shall not be considered. (See section 235-2.3(g), HRS).

(2) Returns. Every person and organization, described in section 235-9, HRS, which is otherwise exempt from income tax and which is subject to income tax imposed on unrelated business taxable income under section 235-2.3(g), HRS, shall file a return for each taxable year if it has gross income of $1,000 or more included in computing unrelated business taxable income for such taxable year. The filing of a return of unrelated business income does not relieve the person or organization of other filing requirements.

(h) With respect to estates and trusts, the following rules apply.

(1) With regard to section 641(a) (with respect to tax on estates and trusts), IRC, as operative under chapter 235, HRS, the applicable tax rates are as set forth in section 235-51(d), HRS.

(A) If an estate or trust has a net capital gain, the estate or trust may elect the alternative tax set forth in section 235-51(f), HRS.

(B) Estates and trusts are not allowed the standard deduction, except that the estate of an individual in bankruptcy shall be allowed the standard deduction in section 235-2.4(a)(4), HRS, pursuant to section 1398(c)(3) (with respect to basic standard deduction in an individual's title 11 case), IRC, if the estate does not itemize deductions.

(C) Estates and trusts shall not use the tax tables to compute tax.

(2) Section 642(a) (with respect to foreign tax credit), IRC, is not operative in Hawaii. A resident trust shall be allowed a credit for taxes paid to another jurisdiction to the extent permitted by section 235-55, HRS, and the rules thereunder, but only in respect of so much of those taxes paid to another jurisdiction that is not properly allocable to any beneficiary. A nonresident trust shall not be allowed the credit in section 235-55, HRS.

(3) Section 642(b) (with respect to deduction for personal exemption), IRC, is not operative in Hawaii. An estate or trust shall be allowed the deduction for personal exemption set forth in section 235-54(b), HRS. A trust shall be eligible for the personal exemption of $200 under section 235-54(b)(2), HRS, if it is required by the terms of its governing instrument to distribute all of its income currently, whether or not the trust is described in section 651 (with respect to simple trusts), IRC.

Example 1: A trust's governing instrument provides that all of its income is to be distributed to charity every year. Although the trust is not a simple trust under section 651, IRC, it is eligible for the $200 personal exemption.

Example 2: A trust's governing instrument provides that $1000 is to be distributed to its sole beneficiary every year. The trust is eligible for the $200 personal exemption in any year in which the trust's income is not more than $1000.

(4) With regard to section 642(d) (with respect to unlimited deduction for amounts paid or permanently set aside for a charitable purpose), IRC, as operative under chapter 235, HRS, an estate or trust shall be allowed a deduction equal to the smaller of the following two amounts:
  (A) The amount allowable under section 681 (with respect to limitation on charitable deduction), IRC; or
  (B) The greater of the amounts in clause (i) and (ii):
    (i) The amount qualifying under section 642(c), IRC, that is paid, or permanently set aside, to be used exclusively in Hawaii for charitable purposes; or
    (ii) The amount qualifying under section 642(c), IRC, that is actually paid for charitable purposes, subject to the percentage limitations in section 170(b)(1) (with respect to percentage limitations applicable to contributions by an individual), IRC. In computing the percentage limitations, the contribution base of the estate or trust shall be adjusted gross income as defined in section 235-1, HRS, computed without regard to any net operating loss carryback to the taxable year.

(5) Section 642(d) (with respect to net operating loss deduction), IRC, is not operative in Hawaii. An estate or trust shall be allowed the net operating loss deduction to the extent permitted by section 235-7(d), HRS, and the rules thereunder.

(6) With respect to section 644 (with respect to gain on property transferred to trust at less than fair market value), IRC, as operative under chapter 235, HRS:
  (A) In section 644(a)(2)(A), IRC, the tax shall be computed under chapter 235, HRS; and
  (B) In section 644(a)(2)(B), IRC, the interest rate shall be that specified in section 231-39(b)(4), HRS.

(7) With respect to section 667 (with respect to treatment of amounts deemed distributed by a complex trust in preceding years), IRC, as operative under chapter 235, HRS:
  (A) In section 667(a)(1) and (2), IRC, the tax shall be computed under chapter 235, HRS; and
  (B) Interest income exempt from Hawaii tax under section 235-7, HRS, in the hands of a trust, retains its character when distributed to a beneficiary pursuant to section 662(b) (with respect to character of amounts distributed), IRC. Other interest income that is not exempt from Hawaii tax in the hands of a trust pursuant to section 235-7(b), HRS, is considered a taxable amount for purposes of computing the tax under section 667, IRC, when that income is distributed.

(8) Section 668 (with respect to interest charge on accumulation distributions from foreign trusts), IRC, is not operative in Hawaii.

(i) to (k) (Reserved)

(l) Capital loss carrybacks and carryovers. (I.R.C. section 1212).

(1) In general. The federal regulations relating to capital loss carrybacks and carryovers in the Internal Revenue Code shall be operative except that the provisions relating to capital loss carryback shall not be operative and the capital loss carryover allowed by I.R.C. section 1212(a) shall be limited to five years. Individual taxpayers shall be allowed capital loss carryovers until exhausted. (See section 235-2.3(l), HRS.)

(m) Subchapter S. (I.R.C. sections 1371 to 1379).

(1) In general. The federal regulations relating to the Internal Revenue Code on election of small business corporation shall be operative subject to certain other requirements and modifications for this State. (See section 235-2.3(l), HRS.)
  (A) A small business corporation shall not have (A) A nonresident as a shareholder; or (B) A resident individual who has taken up residence in the State after age 65 and before 7/1/76 and who is taxed under chapter 235 only on the income from within this State, unless such individual shall have waived the benefit of section 3, Act 60, L. 1976, and

shall have included all income from sources within and without this State in the same manner as if the individual had taken up residence in the State after 6/30/76.

(2) Election. Effective 1/1/79, an election under I.R.C. Section 1372(a) not to be subject to income taxes shall terminate for the taxable year in which such corporation derives more than 80 per cent of its gross income from sources outside the State. Termination shall remain in effect for all succeeding taxable years.

(A) An election under I.R.C. section 1372 shall not be valid unless there is also in effect for such taxable year, an election for federal tax purposes.

(B) The tax imposed by I.R.C. section 1378(a) is hereby imposed by this chapter and shall be at a rate of 3.08 per cent on the amount by which the net capital gain exceeds $25,000.00. For purposes of I.R.C. section 1378(c)(3), the amount of tax to be determined shall not exceed 3.08 per cent of the net capital gain attributable to property described under that section.

(3) Returns. Every small business corporation as described in I.R.C. section 1371 and this article shall file an income tax return for each taxable year on Form N-35, stating specifically items of its gross income and deductions and such other information as required by the form or in the instruction issued thereto provided under section 235-80, HRS. [Eff 2/16/82; am 9/3/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-2.3, 235-2.4)

§18-235-3 (Reserved)

§18-235-4 Amended and renumbered §18-235-4-01, §18-235-4-02, §18-235-4-03, §18-235-4-04, §18-235-4-05, §18-235-4-06, §18-235-4-07, §18-235-4-08. [9/3/94]

HRS §235-4 **§18-235-4-01 Income taxes by the State; residents, nonresidents, corporations, estates and trusts.** As used in sections 18-235-4-02 to 18-235-4-08, and sections 18-235-5-01 to 18-235-5-04:

"Adjusted gross income" or "adjusted gross income from all sources" means the same as in section 62 (with respect to adjusted gross income defined), IRC.

"From whatever source derived" means the same as in section 61(a) (with respect to gross income defined), IRC.

"Hawaii adjusted gross income" means Hawaii source income minus the deductions that are allowed as adjustments to gross income under chapter 235, HRS.

"Hawaii source income" means income received or derived from property owned, services performed, trade or business carried on, and any and every other source in the State.

"IRC" means the Internal Revenue Code of 1986, as operative under chapter 235, HRS.

"Jurisdiction" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision of a foreign country.

"Out-of-state income" means income from whatever source derived, other than Hawaii source income.

"Part-year resident" means an individual who becomes a resident, or ceases to be a resident, during the taxable year.

"State", when not referring specifically to Hawaii, means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or any territory or possession of the United States.

"Taxable in" another jurisdiction means the same as in section 235-23, HRS.

"Territory or possession of the United States" means the same as in section 927(d)(5) (with respect to definition of "possessions"), IRC.

"Without regard to source" means the same as "from whatever source derived". [Eff 2/16/82; am and ren §18-235-4-01 9/3/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-4, 235-5, 235-7, 235-55, 235-97)

HRS §235-4 **§18-235-4-02 Residents taxable on entire income.** (a) A resident, as defined in section 235-1, HRS, is taxable on income from whatever source derived. For a resident, it is immaterial whether the source of the income is Hawaii or another jurisdiction, except that if out-of-state income is taxable in another jurisdiction, a tax credit may be allowed under section 235-55, HRS, and section 18-235-55.

(b) A resident shall not exclude or deduct any income allocated or apportioned to another jurisdiction under the Uniform Division of Income for Tax Purposes Act, sections 235-21 to 235-39, HRS, or section 18-235-5-02.

(c) For rules relating to change of residence during the taxable year, see section 18-235-4-04. [Eff 2/16/82; am and ren §18-235-4-02 9/3/94] (Auth: HRS §§231-3(9), 235-96, 235-118) (Imp: HRS §§235-4, 235-5, 235-7, 235-55, 235-97)

Historical note: §18-235-4-02 is based substantially upon §18-235-4(a). [Eff 2/16/82; am and ren §18-235-4-02 9/3/94]

HRS §235-4 **§18-235-4-03 Nonresidents taxable on Hawaii income.** (a) A nonresident, as defined in section 235-1, HRS, is taxable on Hawaii source income and is not taxable on out-of-state income. A nonresident is not allowed a credit for taxes paid to another state under section 235-55, HRS.

(b) A nonresident shall determine Hawaii source income by allocation and apportionment under the Uniform Division of Income for Tax Purposes Act, sections 235-21 to 235-39, HRS, if:

(1) The nonresident derives income from business activity both within and without the State,

(2) The nonresident's business activity is taxable in both this State and another jurisdiction, and

(3) The income is not derived from the rendering of purely personal services.

Otherwise, a nonresident shall determine Hawaii source income by allocation and separate accounting pursuant to section 235-5, HRS, and section 18-235-5-02.

(c) A nonresident, foreign corporation, or other nonresident taxpayer:

(1) Which acts as a business entity in more than one state;

(2) Whose only activities within the State, either alone or as part of a unitary group, consist of sales and do not include:

(A) Owning or renting real estate or tangible personal property, or

(B) Personal services; and

(3) Whose annual gross sales in or into this State during the tax year are not in excess of $100,000,

may elect to report and pay a tax of 0.5 per cent of such gross sales in lieu of the tax otherwise imposed by chapter 235, HRS. An election under this subsection shall constitute the election described in article III, paragraph 2 of the Multistate Tax Compact, chapter 255, HRS, and provided in section 235-51(e) or 235-71(e), HRS. The election may be made by timely filing the form prescribed by the department for this purpose. The election shall be made not later than the last day prescribed by law (including extensions of time) for filing the net income tax return that otherwise would be filed for the tax year.

(d) If a nonresident files a joint return with a spouse who is a resident for the full taxable year, the tax is imposed on aggregate income for the full taxable year without regard to source. A nonresident spouse filing a joint return does not thereby become a resident for purposes of chapter 235, HRS.

(e) This section shall apply to individuals described in section 3 of Act 60, SLH 1976, namely those who have taken up residence in the State: (1) after attaining the age of sixty-five years, and (2) before July 1, 1976. For those individuals, subsection (c) shall not apply, and no credit for tax paid to another state under section 235-55, HRS, shall be allowed. Any individual may waive the benefits of section 3 of Act 60, SLH 1976, by filing a written election with the department. This subsection shall not apply to any individual who has made such a waiver.

(f) For rules relating to change of residence during the taxable year, see section 18-235-4-04.

(g) For rules used to determine the source of income, see section 18-235-4-08.

(h) For deductions of a nonresident, and rules regarding income from alimony or separate maintenance payments, see section 18-235-5-03. [Eff 2/16/82; am and ren §18-235-4-03 9/3/94] (Auth: HRS §§231-3(9), 235-96, 235-118) (Imp: HRS §§235-4, 235-5, 235-7, 235-22, 235-51(e), 235-52, 235-71(e), 235-93, 235-97, 255-1)

Historical note: §18-235-4-03 is based on §18-235-4(b). [Eff 2/16/82; am and ren §18-235-4-03 9/3/94]

HRS §235-4 **§18-235-4-04 Change of residence during taxable year.** (a) The following rules are applied if during the taxable year the status of a taxpayer changes from resident to nonresident, or from nonresident to resident.

(1) For the period of residence, the tax is imposed on income from whatever source derived, as provided in section 18-235-4-02.

(2) For the period of nonresidence, the tax is imposed on Hawaii source income, as provided in section 18-235-4-03. Part-year residents shall not be eligible for the election in section 18-235-4-03(c).

(3) If it cannot be determined whether all or part of a taxpayer's income was generated during the period of residence, that amount of income shall be multiplied by the ratio that the period of residence bears to the entire taxable year. The product shall be the portion attributable to Hawaii, unless the taxpayer demonstrates to the satisfaction of the department that the result attributes to Hawaii out-of-state income that was received or derived during the period of nonresidence.

(4) The credit for tax paid to another state under section 235-55, HRS, shall be allowed only for tax paid on out-of-state income allocable to the period of residence.

Example: T, an unmarried cash basis calendar year taxpayer, was a resident of Arizona on January 1, 1993. T moved to Hawaii on April 1, 1993, and continued to work as

an insurance agent. T is a Hawaii resident for the remainder of 1993. T received $20,000 as gain from the sale on March 20, 1993, of Arizona real property held for investment. T earned commissions of $25,000 for policies sold after April 1, 1993. T earned initial and renewal commissions of $12,000 for policies sold before that date, $4,000 of which T earned before April 1, 1993. In addition, T had signed a business consulting contract with one Arizona client, for which T was paid an additional $1,200 for services rendered throughout the year. T's Hawaii income is computed as follows:

(1) The $20,000 gain is out-of-state income earned when T was a nonresident. None of it is attributable to Hawaii.
(2) The commissions of $25,000 are from a trade or business carried on in Hawaii, and are Hawaii source income. The commissions were earned when T was a Hawaii resident. All of these commissions are attributable to Hawaii.
(3) The $12,000 in commissions earned before April 1993 is from a trade or business carried on in Arizona, and is thus out-of-state income. However, only $4,000 was earned when T was a nonresident. The remaining $8,000 is attributable to Hawaii.
(4) It cannot be determined whether the remaining $1,200 in commission income was generated while T was a Hawaii resident. Thus, because T was a resident for nine months in 1993, 9/12 x $1,200, or $900, shall be attributable to Hawaii unless T demonstrates otherwise to the satisfaction of the department.

(b) The following rules are applied for joint returns.
(1) If a nonresident or a part-year resident files a joint return with a spouse who is a resident for the full taxable year, the tax is imposed on aggregate income for the full taxable year without regard to source and without regard to either spouse's period of residence.
(2) If a joint return is filed by two individuals neither of whom is a resident for the full taxable year, the tax is imposed on aggregate income without regard to source for the period in which either spouse was a resident.
(3) By filing a joint return, a nonresident spouse does not become a resident, and a part-year resident spouse does not thereby become a resident for any other part of the year, for purposes of chapter 235, HRS.

(c) For deductions of a part-year resident, and rules regarding income from alimony or separate maintenance payments, see section 18-235-5-03. [Eff 2/16/82; am and ren §18-235-4-04 9/3/94] (Auth: HRS §§231-3(9), 235-5(d), 235-96, 235-118) (Imp: HRS §§235-4, 235-5, 235-7, 235-22, 235-52, 235-55, 235-97, 255-1)

Historical note: §18-235-4-04 is based on §18-235-4(f). [Eff 2/16/82; am and ren §18-235-4-04 9/3/94]

HRS §235-4 **§18-235-4-05 Corporations; domestic and foreign.** (a) Domestic corporations, including professional and nonprofit corporations, are subject to tax on Hawaii source income. Domestic corporations also are subject to tax on out-of-state income that is not taxable in another jurisdiction.

(b) Income from business activity within and without Hawaii that is taxable in another jurisdiction shall be apportioned under the Uniform Division of Income for Tax Purposes Act, sections 235-21 to 235-39, HRS. A domestic corporation is subject to tax in Hawaii on income that is allocated or apportioned to any jurisdiction in which that corporation is not taxable.

Example 1: Corporation X, a Hawaii corporation, is actively engaged in selling farm equipment in Hawaii and State A. Both Hawaii and State A impose a net income tax but State A exempts corporations engaged in selling farm equipment. Corporation X is taxable in both Hawaii and State A. Corporation X is not subject to tax in Hawaii on income that is allocated or apportioned to State A.

Example 2: The facts are the same as in Example 1, except that State A may not impose a net income tax on Corporation X because of Public Law No. 86-272, 15 U.S.C. sections 381-384. Corporation X is taxable in Hawaii and is not taxable in State A. Corporation X is subject to tax in Hawaii on income that is allocated or apportioned to State A.

(c) Foreign corporations are subject to tax on Hawaii source income and are not subject to tax on out-of-state income.

(d) For rules relating to corporations for which an election under section 1362 (with respect to S corporations), IRC, is in effect, see section 18-235-122.

(e) For the election available under the Multistate Tax Compact to a foreign corporation whose only activities within the State consist of sales, see section 18-235-4-03(c).

(f) For rules used to determine the source of income, see section 18-235-4-08. [Eff 2/16/82; am and ren §18-235-4-05 9/3/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-4, 235-5, 235-7, 235-22, 255-1)

Historical note: §18-235-4-05 is based upon §18-235-5(a)(2)-(3). [Eff 2/16/82; am 9/3/94]

HRS §235-4 **§18-235-4-06 Resident and nonresident estates, trusts, and beneficiaries.** (a) As used in this section:

"Beneficiary" includes an heir, legatee, devisee, and any person to whom income of a trust is attributed under section 671 (with respect to trust income, deductions, and credits attributable to grantors and others as substantial owners), IRC.

"Beneficiary's share of income" means that portion of the income of an estate or trust: (1) that the beneficiary is required to include in income under subchapter J (with respect to estates, trusts, beneficiaries, and decedents), IRC; or (2) that is attributed to the beneficiary under section 671, IRC.

"Resident beneficiary" means a beneficiary who is a "resident person" within the meaning of section 235-68(a), HRS.

(b) An estate or trust shall report its gross income from whatever source derived, each beneficiary's share of income, and each beneficiary's share of Hawaii source income if:

(1) It is a resident estate or trust, as defined in section 235-1, HRS;
(2) Any of its beneficiaries is a resident beneficiary; or
(3) Any part of its income is attributed to a resident beneficiary under section 671, IRC.

(c) An estate or trust not described in subsection (b) shall report all Hawaii source income, and also shall report each beneficiary's share of Hawaii source income.

(d) An estate or trust shall determine Hawaii source income by allocation and apportionment under the Uniform Division of Income for Tax Purposes Act, sections 235-21 to 235-39, HRS, if:

(1) The estate or trust derives income from business activity both within and without the State,
(2) The estate's or trust's business activity is taxable in both this State and another jurisdiction, and
(3) The income is not derived from the rendering of purely personal services.

Otherwise, an estate or trust shall determine Hawaii source income by allocation and separate accounting pursuant to section 235-5, HRS, and section 18-235-5-02.

(e) A resident estate or trust is taxable on income from whatever source derived, whether or not the administration of the estate or trust is principal, ancillary, or carried on in this State. A resident estate or trust shall not exclude or deduct any income allocated or apportioned to another jurisdiction under the Uniform Division of Income for Tax Purposes Act, sections 235-21 to 235-39, HRS. If a resident estate or trust has out-of-state income that is taxable in another jurisdiction, a tax credit may be allowed under section 235-55, HRS, and section 18-235-55.

(f) A nonresident estate or trust is taxable on Hawaii source income and is not taxable on out-of-state income.

(g) A beneficiary is subject to tax on that beneficiary's share of income as if the beneficiary had received that income directly, and had directly incurred any deductions allowable under subsection (h), whether or not the estate or trust is a resident, and whether or not the estate or trust is required to file a return.

(1) A resident beneficiary is subject to tax upon that beneficiary's share of income from whatever source derived.
(2) A nonresident beneficiary (or a beneficiary taking up residence in the State after attaining the age of sixty-five years but before July 1, 1976) is subject to tax upon that beneficiary's share of Hawaii source income. If a nonresident beneficiary of a resident trust derives income from intangibles, see section 235-4.5, HRS.

(h) In computing an estate's or trust's Hawaii adjusted gross income or taxable income, or any beneficiary's share of Hawaii source income, deductions shall be allowed only to the extent permitted by section 235-5(c), HRS, and section 18-235-5-03.

(i) The recipient of income in respect of a decedent is subject to tax as if the decedent had received that income directly, and had directly incurred any deductions, losses, or credits allowable to the recipient under section 691 (with respect to recipients of income in respect of decedents), IRC. In computing a recipient's allowable deductions, see section 235-5(c), HRS, and section 18-235-5-03. Thus, if the decedent were a resident at the time of death, the recipient, whether or not a resident, is subject to tax upon the income whether or not it is Hawaii source income. [Eff 2/16/82; am and ren §18-235-4-06 9/3/94] (Auth: HRS §§231-3(9), 235-96, 235-118) (Imp: HRS §§235-4, 235-5, 235-7, 235-22, 235-94(d))

Historical note: §18-235-4-06 is based on §§18-235-2.3(h)(8)(E), (h)(9), (h)(10) [Eff 2/16/82; am 9/3/94], and 18-235-4(c), (d), and (g)(4). [Eff 2/16/82; am and ren §18-235-4-06 9/3/94]

HRS §235-4 **§18-235-4-07 Resident and nonresident partners of a partnership.** (a) A resident partner is subject to tax on the partner's distributive share of the partnership income from whatever source derived.

(b) A nonresident partner is subject to tax on the partner's distributive share of Hawaii source income.

(c) Partners of a partnership shall be subject to tax on their distributive shares of partnership income whether or not the partnership is required to file a return.

(d) A partnership shall determine Hawaii source income by allocation and apportionment under the Uniform Division of Income for Tax Purposes Act, sections 235-21 to 235-39, HRS, if:

(1) The partnership derives income from business activity both within and without the State,

(2) The partnership's business activity is taxable in both this State and another jurisdiction, and

(3) The income is not derived from the rendering of purely personal services.

Otherwise, a partnership shall determine Hawaii source income by allocation and separate accounting pursuant to section 235-5, HRS, and section 18-235-5-02.

(e) A partnership return made pursuant to section 235-95, HRS, shall report the gross income, gains, losses, deductions, and credits from whatever source derived, and each partner's distributive share of those items. The partnership also shall report each partner's distributive share of income, gains, losses, deductions, and credits from sources within the State.

(f) For corporations that are partners of a partnership, see section 18-235-4-05. [Eff 2/16/82; am and ren §18-235-4-07 9/3/94] (Auth: HRS §§231-3(9), 235-96, 235-118) (Imp: HRS §§235-4, 235-5, 235-7, 235-95)

Historical note: §18-235-4-07 is based substantially on §18-235-4(e). [Eff 2/16/82; am and ren §18-235-4-07 9/3/94]

HRS §235-4 **§18-235-4-08 Source of income.** (a) Income derived from real or tangible personal property is sourced at the place where the property is owned, namely the place where the property has its situs. If tangible personal property is owned and used in different locations, income from the property shall be allocated as provided in section 235-25, HRS.

(b) Income from intangible property, such as interest and dividends, is sourced at the place of the owner's domicile unless the property has acquired a business situs at another place, in which event the income is sourced at that place. Intangible property has a business situs in this State if it is employed as capital in this State or the possession and control of the property has been localized in this State.

Example 1: A corporation owns stocks, bonds, and other intangible personal property. It pledges the property in Hawaii as security for the payment of indebtedness, taxes, and other expenses incurred in connection with a business in this State. The pledged property has a business situs in Hawaii.

Example 2: A corporation maintains a branch office here and opens a bank account on which the agent in charge of the branch office may draw for the payment of expenses in connection with the activities in this State. The bank account has a business situs in Hawaii.

Example 3: The corpus of a trust contains United States Treasury bills, bank certificates of deposit, and shares of preferred and common stock. The trustee of the trust, a Hawaii corporation, exclusively holds, controls, and administers the corpus of the trust. The trustee is permitted broad discretion to invest trust income and accumulations and is responsible for the collection and disbursement of any income generated by the trust assets. The property forming the corpus of the trust has a business situs in Hawaii. Thus, the trust's income is Hawaii source income; however, the exclusion in section 235-4.5, HRS, may apply in some cases.

(c) Income from an interest in real property, such as a leasehold, has its situs where the real property is located. The situs of the purchaser's interest under a contract for the sale of real property is where the real property is located.

(d) Income from a trade or business is sourced at the place where the trade or business is carried on.

(e) Income from the performance of personal services has its source at the place where the services are performed.

(f) A gain or loss on the sale or other disposition of property has its source at the place where the property was owned, that is, where it had its situs, at the time of the sale or other disposition. This rule applies whenever gain or loss is considered as resulting from the sale or other disposition of the underlying property,

irrespective of where the contract for the sale or other disposition of the property was made. Thus, if property is disposed of on the installment method, the portion of any installment payment that represents gross profit is income that has its source at the place where the underlying property had its situs at the time of disposition.

Example: Y is the vendor on an agreement of sale for real property on Kauai. In 1994, Y sells Y's interest to S and realizes a gain of $5,000 under section 453B (with respect to gain or loss on disposition of installment obligations), IRC. Under section 453B, IRC, the gain is considered to be from the sale or exchange of the property in respect of which the installment obligation was received. Thus, because the underlying property is located in Hawaii, the $5,000 is Hawaii source income. [Eff 2/16/82; am and ren 9/3/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-4, 235-5, 235-7)

Historical note: §18-235-4-08 is based substantially upon §18-235-4(g)(1)-(7). [Eff 2/16/82; am and ren §18-235-4-08 9/3/94]

§18-235-5 Amended and renumbered §18-235-5-01, §18-235-5-02, §18-235-5-03, §18-235-5-04. [9/3/94]

HRS §235-5 **§18-235-5-01 Allocation of income of persons not taxable upon their entire income.** (a) The definitions contained in section 18-235-4-01 apply to sections 18-235-5-01 to 18-235-5-04.

(b) The rules contained in sections 18-235-5-01 to 18-235-5-04 apply to taxpayers having only nonbusiness income, individual taxpayers having income from the rendering of purely personal services, and public utilities taxable under chapter 239, HRS, whether determining Hawaii source income or out-of-state income.

(c) In computing the unrelated business taxable income of a tax exempt organization under sections 512 to 514 (with respect to unrelated business taxable income, unrelated trade or business, and unrelated debt-financed income), IRC, that is subject to tax in Hawaii, sections 235-21 to 235-39, HRS, shall apply.

(d) Taxpayers described in subsection (b) shall use these rules for determining estimated tax, determining the amount of credit permitted under section 235-55, HRS, and other purposes that require allocation or apportionment of income between jurisdictions. Other taxpayers shall use sections 235-21 to 235-39, HRS, for those purposes.

(e) Section 235-5(c), HRS, and section 18-235-5-03 apply to all taxpayers. [Eff 2/16/82; am and ren §18-235-5-01 9/3/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-4, 235-5, 235-7)

Historical note: §18-235-5-01 is based upon §18-235-4(g)(8). [Eff 2/16/82; am and ren 9/3/94]

HRS §235-5 **§18-235-5-02 Allocation and separate accounting.** (a) Taxpayers described in section 18-235-5-01(b) who are required to determine Hawaii source income shall determine Hawaii source income by allocation and separate accounting.

(1) If the nature of the taxpayer's activity renders direct allocation impracticable, or the taxpayer's books of account and records do not clearly reflect income properly taxable by Hawaii, income shall be allocated or apportioned under sections 235-21 to 235-39, HRS.

(2) Income also shall be allocated or apportioned under sections 235-21 to 235-39, HRS, when the activity within the State is an integral part of a unitary business carried on within and without the State.

(b) When the separate accounting method is used, separate records shall be maintained for sales, cost of sales, and expenses which are attributable to activity within Hawaii. Overhead expenses not directly allocable to activity within or without Hawaii shall be allocated according to the facts and circumstances, and in conformity with generally accepted accounting principles.

(c) If the director of taxation determines that the method set forth in this section does not fairly determine income derived from or attributable to Hawaii, the director may direct or permit the use of an allocation method or apportionment formula based on other factors that would more clearly reflect income attributable to Hawaii. A taxpayer may petition the director of taxation to use an apportionment formula other than that specified in section 235-29, HRS, by written request pursuant to section 235-38, HRS.

(d) A change in the taxpayer's allocation method or apportionment formula is a change in the taxpayer's method of accounting within the meaning of sections 446 (with respect to methods of accounting) and 481 (with respect to adjustments required by changes in method of accounting), IRC. [Eff 2/16/82; am and ren §18-235-5-02 9/3/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-5)

Historical note: §18-235-5-02 is based upon §18-235-5(a)(1) and (b)(1), (3). [Eff 2/16/82; am and ren §18-235-5-02 9/3/94]

HRS §235-5 **§18-235-5-03 Deductions connected with gross income from Hawaii sources.** (a) This section applies to all taxpayers, pursuant to section 235-5(c), HRS, and section 265 (with respect to expenses and interest connected with tax-exempt income), IRC.

(b) In computing the taxable income of a taxpayer subject to tax on Hawaii source income only:

(1) Deductions connected with Hawaii source income shall be allowed.

(2) Deductions connected with out-of-state income shall not be allowed.

(3) Pursuant to section 235-7(e), HRS, no deduction is allowed for interest paid or accrued on debt incurred or continued:

(A) To purchase or carry bonds if interest paid by the bond issuer is out-of-state income or is exempt from taxation under section 235-7(a), HRS;

(B) To purchase or carry property owned outside of the State; or

(C) To carry on a trade or business outside of the State.

(4) Deductions from Hawaii adjusted gross income that are not connected with particular property or income, such as medical expenses, shall be allowed only to the extent of the ratio of Hawaii adjusted gross income to adjusted gross income from all sources.

(5) Adjustments to income that are not connected with particular property or income shall be allowed only in the proportion determined under the following formula.

(A) Determine the aggregate amount of the adjustments not connected with particular property or income.

(B) Determine Hawaii source income and subtract all adjustments to income other than those included in (A).

(C) Add the amount in (A) to adjusted gross income from all sources.

(D) The ratio of (B) to (C) is the proportion of the adjustments that are allowable.

(6) Deductions are connected with a particular kind of income if the deductions would be allocable to that income under the principles of section 265 (with respect to expenses and interest connected with tax-exempt income), IRC, and section 1.265-1(c) (with respect to allocation of expenses to a class or classes of exempt income), Treasury Regulations.

Example: T, a single person aged 60, is a nonresident owning rental property in the State from which T derives $3,500 of gross income during the taxable year and incurs $500 of associated expenses, such as general excise and real property taxes. T also has paid $1,500 in interest on a mortgage on T's personal residence in Iowa. T's adjusted gross income from all sources is $12,000. During the taxable year, T's expenses of medical care, qualifying as such under section 213 (with respect to medical, dental, and similar expenses), IRC, are $1,000.

(1) Because the $500 in expenses is attributable to the rental property in Hawaii, the entire amount is allowed as a deduction. T therefore has $3,500 - $500, or $3,000, in Hawaii adjusted gross income.

(2) Because the $1,500 in interest is connected with real property outside Hawaii, no part of that amount is allowed as a deduction against Hawaii income.

(3) The $1,000 of medical expenses, wherever incurred, is not connected with any particular property or income. Thus, it shall be prorated by applying the ratio of Hawaii adjusted gross income to adjusted gross income from all sources. In this case the result is ($3,000/$12,000 x $1,000), or $250. If T does not take the standard deduction, T may deduct medical expenses in excess of 7.5 per cent of T's Hawaii adjusted gross income. Because 7.5 per cent of $3,000 is $225, T's medical expense deduction for Hawaii purposes is limited to $250 - $225, or $25.

(c) If a taxpayer is taxable only upon Hawaii source income and the taxpayer's deductions connected with out-of-state income exceed the amount of out-of-state income, the excess shall not be deductible against Hawaii source income and shall not be carried over or carried back to offset Hawaii source income in any other taxable year.

(d) If a taxpayer is a part-year resident, the following procedure shall be followed.

(1) Income shall be allocated between the period of residence and the period of nonresidence, under section 18-235-4-04.

(2) Deductions shall be allocated between those connected with income allocable to the period of residence, and those connected with income allocable to the period of nonresidence. Deductions shall be allocated in the same ratio as the connected income, unless the taxpayer demonstrates to the satisfaction of the department of taxation that the result materially distorts Hawaii income.

(3) Deductions connected with income allocable to the period of residence shall be allowed.

(4) Other deductions shall be allowed or disallowed under the principles in subsections (b) and (c), but in applying those subsections to a part-year resident, Hawaii adjusted gross income shall include all income and adjustments allocable to the period of residence.

(5) If a joint return is filed by two taxpayers neither of whom was a resident for the full taxable year, the period of residence shall be the period in which either spouse was a resident, and the period of nonresidence shall be the period in which neither spouse was a resident.

Example: T, an unmarried cash basis calendar year taxpayer, was a resident of Arizona on January 1, 1993. T moved to Hawaii on April 1, 1993, and continued to work as an insurance agent. T is a Hawaii resident for the remainder of 1993. T received $20,000 as gain from the sale on March 20, 1993, of Arizona real property held for investment. T earned commissions of $25,000 for policies sold after April 1, 1993. T earned initial and renewal commissions of $12,000 for policies sold before that date, $4,000 of which T earned before April 1, 1993. In addition, T had signed a business consulting contract with one Arizona client, for which T was paid an additional $1,200 for services rendered throughout the year. (For analysis of T's income, see section 18-235-4-04(a), Example.)

(1) On January 15, 1993, T paid $100 to renew T's Arizona insurance agent's license. None of the $100 is deductible against Hawaii income because the license only relates to out-of-state income received when T was a nonresident.

(2) T incurs $3,600 in business expenses connected with T's business as an insurance agent, but the expenses cannot be connected to specific sales of policies. As explained in section 18-235-4-04(a), Example, $33,900 of the $38,200 of commission income is allocable to T's period of residence. Thus, ($33,900 / $38,200) x $3,600, or $3,195, of the expenses are allocable to the period of residence and are deductible as trade and business deductions. Because the remaining commission income is out-of-state income allocable to a period of nonresidence, the remaining $405 of expenses is not deductible unless T demonstrates to the satisfaction of the department that the result materially distorts income.

(3) T pays $2,000 to an accountant to prepare T's tax return. T's adjusted gross income from all sources is $20,000 - $1,500 + $38,200 - $3,600, or $53,100, and T's Hawaii adjusted gross income, which includes T's out-of-state income earned while T was a Hawaii resident, is $33,900 - $3,195, or $30,705. Because T's tax return preparation expenses are not connected with particular property or income, the amount allowable in Hawaii is ($30,705 / $53,100) x $2,000, or $1,156. The tax return preparation expense is a miscellaneous itemized deduction subject to the 2 per cent floor of section 67, IRC. If T does not take the standard deduction and has no other miscellaneous itemized deductions, T may deduct the amount in excess of 2 per cent of Hawaii adjusted gross income, so the deductible amount is $1,156 - (0.02 x $30,705) = $542.

(e) This subsection applies to payments of alimony or separate maintenance.

(1) As used in this subsection:

"Alimony" means the same as "alimony or separate maintenance payment" in sections 71(b) (with respect to alimony and separate maintenance payments) and 215 (with respect to deduction for alimony and similar payments), IRC.

"Contributing spouse" means the spouse, or former spouse, who pays alimony.

"Recipient spouse" means the spouse, or former spouse, who receives alimony.

(2) Alimony is included in the gross income of the recipient spouse where:

(A) The recipient spouse is a resident;

(B) The recipient spouse became a resident after attaining the age of sixty-five and before July 1, 1976, and either the contributing spouse is a resident or the payments are attributable to property owned in the State that is transferred (in trust or otherwise) in discharge of a legal obligation to make alimony payments; or

(C) The recipient spouse is a nonresident, the contributing spouse is a resident, and the payments are attributable to property owned in the State that is transferred (in trust or otherwise) in discharge of a legal obligation to make alimony payments.

(3) Alimony is deductible from the income of the contributing spouse as follows:

(A) If the contributing spouse is a resident for the full taxable year, the payment of alimony is deductible in full; or

(B) If the contributing spouse is not a resident for the full taxable year, the payment of alimony shall be prorated under subsection (b)(4) to yield the deductible amount.

(f) This subsection applies to deductions by individual taxpayers for contributions to pension, profit sharing, stock bonus, and similar plans.

(1) An individual's deduction for contributions to a retirement plan, such as that under sections 219 (with respect to retirement savings), 404(a)(8) (with respect to deduction for contributions of self-employed individuals), or 408 (with respect to individual retirement accounts), IRC, shall be allowed only to the extent that the deduction is attributed to compensation earned:

(A) In this State, or

(B) While the individual was a resident.

(2) As used in this subsection, "compensation" means the same as in section 219(f)(1), IRC.

(3) An individual's deduction for contribution to an individual retirement account shall be presumed to be made pro rata from all compensation earned during the taxable year in which the contribution is deductible.

(4) A rollover contribution, as described in section 219(d)(2), IRC, shall not be reduced or disallowed under this subsection.

(5) For rules to determine where compensation is earned, see section 235-34, HRS.

Example: In 1994, T earned $30,000 in California while residing there and working for BMI Co. On May 13, 1994, T moved to Hawaii to work for Exrox Co. and earned $20,000 during 1994. After the move, T rolled over the entire BMI Co. retirement plan balance to an individual retirement account (IRA). T established another IRA in Hawaii and contributed $2,000 on April 1, 1995, that is deductible for federal purposes in 1994. T is a part-year resident. Under paragraph (4), T's establishment of the rollover IRA is not subject to tax. Under paragraph (3), the $2,000 IRA contribution is prorated between all compensation sources. Hawaii compensation is $20,000 and total compensation is $50,000. Thus, $2,000 x ($20,000 / $50,000), or $800, is considered to be from Hawaii compensation and is thus deductible in Hawaii. [Eff 2/16/82; am and ren §18-235-5-03 9/3/94] (Auth: HRS §§231-3(9), 235-5(d), 235-118) (Imp: HRS §§235-4, 235-5, 235-7)

Historical note: §18-235-5-03 is based upon §18-235-5(c). [Eff 2/16/82; am and ren §18-235-5-03 9/3/94]

HRS §235-5 **§18-235-5-04 Allocation of income and deductions among taxpayers.** (a) If two or more organizations, trades, or businesses, whether or not incorporated or organized in Hawaii, are owned or controlled directly or indirectly by the same interests, the director may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among the organizations, trades, or businesses, if the director determines that the distribution, apportionment, or allocation is necessary in order to clearly reflect the income attributable to any taxpayer's activity in this State.

(b) This section shall not be construed to permit the filing of consolidated returns by two or more affiliated corporations except as provided by section 235-92, HRS.

(c) The director shall not allocate or apportion income to Hawaii in excess of what is considered just and reasonable under the circumstances. [Eff 2/16/82; am and ren §18-235-5-04 9/3/94] (Auth: HRS §§231-3(9), 235-5(d), 235-118) (Imp: HRS §235-5)

Historical note: §18-235-5-04 is based substantially upon §18-235-5(b)(4). [Eff 2/16/82; am and ren §18-235-5-04 9/3/94]

HRS §235-5 **§18-235-5.5 Individual housing accounts (IHA).** (a) Allowance deduction.

(1) An individual taxpayer, also referred to as a participant, including a married individual, shall be allowed a deduction from gross income the amount paid in cash during the taxable year to an individual housing account. Except as otherwise provided, any interest paid or accrued on the account shall not be included in gross income.

(2) The deduction shall not exceed $5,000 for each taxable year. The aggregate amount allowable shall not exceed $25,000. These amounts shall be exclusive of any interest paid or accrued.

(b) Special rules for married individuals; separate accounts. Each married individual shall be allowed to maintain a separate individual housing account.

Where separate accounts are maintained, each married individual shall be allowed to deduct from gross income the amount paid into the account in cash but not to exceed $5,000 for each taxable year. The amount of interest paid or accrued shall be excluded and disregarded in the determination of the $5,000.

In determining the maximum aggregate amount allowable, the accounts of each married individual shall be combined and the total aggregate amount shall not exceed $25,000.

(c) Special rules for married individuals; joint accounts. Where a married individual maintains a joint account with the individual's spouse, it shall be deemed to be a single individual housing account. There shall be allowed as deduction from gross income only that amount paid into the joint account but not to exceed $5,000 for each taxable year, or an aggregate of $25,000 for all taxable years. The limitation shall apply whether or not each of the spouses files separate income tax returns.

Where married individuals file separate returns, unless otherwise shown, the presumption is that both spouses contributed to the account and each spouse will be allowed to deduct one-half of the amount paid into the account. Where, by satisfactory proof of deposit, either spouse shall satisfy the director of taxation that the payments made into the account were derived from income earned solely by the spouse, the individual shall be allowed to deduct the amount of such payments from the individual's gross income.

(d) Time for payment. Payment to the individual housing account shall be made no later than December 31 of the tax year for which the amounts are claimed as a deduction. Where the taxable year is other than a calendar year the payment shall be made no later than the last day of such year for which the amounts are to be claimed as a deduction.

(e) Eligibility. To be eligible for the deduction, neither the individual nor the individual's spouse shall have had any prior interest in residential property either within or without the State and the individual, during the period such account is maintained, shall not acquire any interest in any residential property regardless where located.

The term "interest in residential property" shall mean any legal interest as joint tenants, tenants by the entirety, or tenants in common or tenancy be severalty whether by way of a leasehold or fee simple estate in all or part of a house, townhouse, condominium or cooperative apartment, or any other property used as a principal residence.

(f) Requirements for an individual housing account.

(1) Exclusive benefit. An individual housing account shall be created as a trust account established in the State of Hawaii for the exclusive benefit of an individual, whether or not the individual is married.

The principal purpose of the trust is to create a special savings fund to provide an adequate incentive for the people of this State to become owners of their own home.

(2) First principal residence. An individual housing account shall be allowed only for the purchase of a first principal residence in this State. No account shall be established for any individual who either currently owns or formerly owned a principal residence, or had any interest in residential property whether or not the principal residence or residential property is located within or without the State. For married individuals, the limitation applies equally to either spouse.

The term "principal residence" shall mean the dwelling unit where the individual actually lives in and intends to be the individual's fixed abode. The individual shall physically reside in the dwelling unit with an intention to make that dwelling unit the individual's home. There shall be a presumption that the dwelling unit in which an individual lives is that individual's principal residence. If a portion of a building is used for some purpose other than as a dwelling unit, for example, a portion of a building is used for a trade or business, only the portion used as a dwelling unit shall be considered a residence.

(g) Qualifying institutions and disclosure requirements. Qualifying institutions. Only individual housing accounts maintained with a bank, savings and loan association or credit union meeting the following requirements may qualify for the deduction and exemptions:

(1) Actively making residential real estate mortgage loans in Hawaii.

(A) The fact that no mortgage money is available or that no loans have been made because of high interest rates shall not, alone, disqualify a lending institution from becoming a qualified institution.

(B) The fact that the lending institution has made no loans during a period when other financial institutions have been making loans for the purchase of real property in the State shall raise a presumption that the institution is not actively making residential real estate loans in this State.

(C) Where a lending institution, when the account has been first opened, was actively making residential real estate mortgage loans but has since ceased to actively make such loans, it may:

(i) continue to maintain an existing account;

(ii) not open new accounts;

(iii) not attempt transfer of housing accounts.

(2) Be ready and willing to make residential real estate mortgage loans in Hawaii regularly throughout the year.

(h) Statement of individual housing account. Each individual who claims the deduction for an individual housing account shall attach to the individual's income tax return, a disclosure statement on the form prescribed by the director of taxation, to be completed by the lending institution. A copy of the form is attached hereto as Exhibit I, entitled "Statement of Individual Housing Account," August 1, 1983, located at the end of this section.

Requirements of disclosure statement to individual. Each lending institution shall furnish the individual a disclosure statement whenever an individual housing account is established on a form prescribed by the director of taxation. A copy of the form is attached hereto as Exhibit II, entitled "Disclosure Statement for Individual Housing Accounts," August 1, 1983, located at the end of this section. The statement shall explain in nontechnical language the income tax consequences of establishing an individual housing account and the limitations and restrictions of the account.

(i) Termination of account. The individual housing account shall terminate in the following circumstances:

(1) The account shall terminate whenever all or part of the account is used for the purchase of a first principal residence which is located in Hawaii. No deduction shall be allowed for deposits made after the termination.

(2) Upon earlier withdrawal of funds from the account other than for the purchase of a first principal residence.

(3) Upon the expiration of 120 months from the date of the first deposit to the account. In case of a housing account into which funds from another account have been transferred, the account shall terminate upon the expiration of 120 months from the date of the first deposit to the account which was first opened in time.

All amounts in the account on the termination date shall be distributed to the participant subject to the requirements relating to married individuals with a joint account.

Except where the amounts have been used to purchase a principal residence, any amounts remaining in the account on the termination date shall be treated as a distribution and shall be included in gross income in the taxable year in which the termination date falls and shall be subject to the additional tax for failure to use for a first principal residence.

(j) Excess contributions. Where two individuals who have separate individual housing accounts become married to each other and thereafter convert their separate account into a single joint account, and the sum of their individual accounts exceeds the allowable amounts for a joint account, the excess resulting from the conversion shall not be deemed in violation of this section. No additional deposits may be paid into the account for each year there exists an excess of contributions. The excess shall be credited to the account in the next immediately succeeding year as though a deposit had been made but the amount of the credit shall not exceed $5,000 for that year. Should there still exist an excess contribution in the account, the excess shall then be credited to the next succeeding and subsequent year. In the event the excess contributions exceed the total aggregate amount of $25,000, any and all amounts in excess of $25,000, exclusive of interest and additions, shall be withdrawn by the participant with no penalty assessed. Such withdrawal shall be made in the taxable year in which the excess contributions was made.

(k) Duties of trustee. In general. The trustee shall accept only cash deposits. The deposit of stocks, bonds, debentures, mutual funds, real estate, or otherwise, shall not be accepted into the account.

(1) The trustee shall not accept deposits in excess of $5,000 for a single taxable year or in excess of $25,000 in the aggregate for all taxable years.

(2) The trustee shall not establish a housing account for an individual unless the trustee receives a written statement from the individual indicating that the individual and, if married, the individual's spouse, does not currently own and has never owned a principal residence, and had no interest in residential property whether in Hawaii or in any other state or country.

(3) The trustee shall distribute the entire amount in an account within 120 months after the first deposit to the account. The transfer of any amounts in a housing account to an account which is not a housing account, shall be deemed to constitute a distribution of the account. All such transfers shall be treated as withdrawals not used for the purchase of a first principal residence, as provided in this section, and the trustee shall withhold the required tax.

(4) For each withdrawal other than for death or disability, the trustee shall withhold the prescribed taxes, unless it verifies in accordance with this section that all or a part of the withdrawal is being used for the purchase of a first principal residence that is located in Hawaii and makes the instrument of payment payable to the seller or the seller's designee (other than the participant), construction contractor or other vendor of the property.

(5) The trustee shall furnish the written disclosure statement required by section 18-235-5.5(c), Administrative Rules, and a copy of the governing instrument as well as any amendments made subsequent thereto, to each person who establishes a housing account.

(6) The trustee may invest assets of the trust only in fully insured savings or time deposits. Certificates of deposit shall qualify as savings or time deposits. Assets of a housing account trust shall not be invested in any other types of assets, e.g., stocks, bonds, notes, debentures, mutual funds or otherwise.

(7) The trustee may commingle funds held in housing account trusts for purposes of investment but the trustee shall maintain individual records on each account in accordance with this rule.

(l) Report and verification by trustee of withdrawals used for the first principal residence in Hawaii. Before allowing a withdrawal from a housing account, the trustee shall either withhold the tax prescribed by subsection (m) below, or verify that the withdrawal is being used for the purchase of a first principal residence that is located in Hawaii. The verification shall be supplied on a form prescribed by the director of taxation which is to be completed by the participant and furnished to the trustee. The prescribed form is attached hereto as Exhibit III, entitled "Request for Withdrawal to Purchase First Principal Residence," August 1, 1983, located at the end of this section.

The trustee shall file a copy of this form with the director of taxation at the time that the trustee files the annual information return for the particular account.

(m) Withholding requirements. The trustee shall withhold an amount equal to ten per cent of the amount of any withdrawal and remit the amount within ten days to the director of taxation unless the trustee satisfies one of the following requirements:

(1) Verifies in accordance with this rule that the withdrawal is used for the first purchase of a principal residence located in Hawaii, and makes the withdrawal payable to the person or entity from whom the residence is being purchased, the person's designee, other than the participant, construction contractor or other vendor of the property either alone or jointly with the participant, or

(2) Verifies in accordance with this section that the participant has died or is disabled; or

(3) Determines that the withdrawal is of an excess contribution and is withdrawn by the due date of the tax return for the taxable year in which the excess contribution was made.

The trustee shall be personally liable for the amount of any tax required to be withheld under this section.

(n) Penalties. For each instance in which a trustee fails to timely file or furnish a report or return required by this section with either the director of taxation or with the individual participant, a penalty of $10 shall be due from the trustee and shall be paid to the director of taxation.

(o) Tax treatment of housing account distributions, generally. Except as otherwise provided in this section, any amount actually paid or distributed or deemed paid or distributed from a housing account shall be included in the gross income of the participant for the taxable year in which the payment or distribution is received. In addition, the tax liability of the participant shall be increased by an amount equal to ten per cent of the amount of the distribution which is includible in the participant's gross income for the taxable year.

(p) Exemption from tax for distributions used for a first principal residence.

(1) Amounts withdrawn from a housing account that are used exclusively in connection with the first purchase of a principal residence in Hawaii shall not be included in gross income in the taxable year withdrawn.

(2) If the participant is building a new residence or purchasing and remodeling an existing residence (or having a contractor do it for the individual), all amounts incurred or to be incurred in such construction or purchase shall not be included in gross income.

In order to qualify as an amount "used exclusively in connection with the first purchase of a principal residence," the amount withdrawn shall be made payable to the person or entity from whom the property is being purchased. This may include the seller, vendor, contractor, or designee of one of them (other than the participant), or the materials or labor being purchased. The amount may be made payable to such person or entity, alone, or jointly with the participant.

(3) Use of an amount from a housing account pursuant to a written earnest money agreement shall be considered as use for the first purchase of a principal residence, if all other requirements are met. If the sale is not completed and the money is either forfeited pursuant to the earnest money agreement or immediately redeposited in the housing account, no tax consequences shall result.

(4) Only the participant may use the account for the purchase of the participant's own first principal residence. It cannot be used to purchase a residence for someone else, for example, by gift, loan, or rental to another.

(5) A participant shall not deduct or exclude the same item twice, under different provisions of law. For example, when the participant makes a withdrawal from a housing account and uses it for the first purchase of a principal residence, if any portion of the withdrawal is used to pay interest expense in connection with the purchase of the residence, no deduction shall be allowed for the portion so used, since interest expense is deductible under another provision of law.

(6) No adjustment to the basis of the residence that is purchased is required because of the use of amounts from a housing account.

(7) In order to claim exemption from income tax of amounts used for a first principal residence in Hawaii, the participant shall attach to participant's income tax return for the taxable year a copy of the verification form that participant furnished the trustee as well as a copy of the closing statement, if any, from the purchase of the residence. The participant shall also furnish any additional information that the director of taxation may request to verify that all requirements of this section have been met.

(q) Distribution incident to divorce. The transfer of a participant's interest, in whole or in part, in an individual housing account to the participant's former spouse under a valid divorce decree or a written instrument incident to the divorce shall not be considered to be a distribution from the housing account. The interest transferred to the former spouse shall be treated as a housing account of that spouse, subject to the requirements of this section.

(r) Distribution upon death. Upon the death of a participant, the funds in the account shall be paid to the participant's estate and shall not be deemed to constitute a taxable distribution for purpose of this section.

(1) If the account was held jointly by the decedent and a spouse of the decedent, and the funds are paid to the surviving spouse, the payment shall not be deemed to constitute a taxable distribution.

(2) The surviving spouse may elect to continue the housing account, subject to the requirements of this section and the election shall not be deemed to constitute a taxable distribution.

(s) Distribution upon total disability. The withdrawal of funds from a housing account by a participant who is totally disabled shall not be deemed to constitute a taxable distribution.

The disability shall be certified to by the department of health or by any state, or county medical officer as required by Section 235-1, HRS.

(t) Transfers of housing accounts.

(1) The term "transfer" shall mean a transfer of the entire amount in a housing account in one financial institution or credit union to a new housing account in another financial institution or credit union.

(2) The transfer of a housing account shall not be treated as a withdrawal from the first account as long as the requirements of this rule are met with respect to the second account. The amount transferred shall neither be included in gross income in the year of the transfer nor subject to the ten per cent tax for not being used for the purchase of a first principal residence in Hawaii.

(3) A transfer shall qualify under this section if the entire interest in the housing account is transferred to a new housing account and the original account is closed and terminated. A participant shall not have more than one account at any one time. The funds in an account to be transferred shall be promptly transferred from one financial institution or credit union to another. Any use of the funds for any purpose other than the purchase of a first principal residence in the interim shall be treated as a withdrawal not used for a first principal residence and shall be included in gross income and made subject to the additional tax.

(4) The housing account into which the funds have been transferred shall terminate 120 months from the date the earliest account was established and the written trust agreement shall so provide. The participant shall inform the new trustee that the deposit is a transfer of a housing account, rather than a new account, and the date of the first deposit to the original account.

(5) The trustee of the account to be transferred shall not be subject to the withholding requirements of this section if it received a written declaration from the participant of the participant's intention to transfer the account. The trustee shall make the instrument of payment payable to the new trustee, either alone or jointly with the participant. The trustee within ten days shall file a copy of the declaration with the director of taxation and shall note thereon the date the funds have been transferred and shall identify the lending institution to which the funds have been transferred.

(u) Tax treatment upon the subsequent sale or conveyance of residential property which was purchased with a housing account distribution.

(1) In General. Upon the sale or conveyance of residential property which was purchased with a housing account, an amount equal to the original distribution and an additional ten per cent of the distribution shall be included in the gross income of the individual.

(2) Sale due to death or total disability of the participant or the participant's spouse. There shall be no tax liability where the residential property purchased by a housing account has been sold due to the death or total disability of a participant or the participant's spouse. [Eff 10/8/83] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-5.5)

§18-235-6 (Reserved)

§18-235-7 Amended and renumbered §§18-235-7-01 to 18-235-7-15. [12/8/94]

HRS §235-7(a)(1) **§18-235-7-01 Exclusion of income nontaxable under the Constitution or laws of the United States.** (a) Section 235-7(a)(1), HRS, excludes income that is not subject to taxation by the State under the Constitution and laws of the United States, if and to the extent that federal law so requires.

(b) Public Law No. 86-272, codified at 15 U.S.C. §§381-384, causes the exclusion under section 235-7(a)(1), HRS, to apply. Section 235-6, HRS, is a separate provision and shall not be construed to expand in any way the exclusion provided by Public Law No. 86-272 and section 235-7(a)(1), HRS. [Eff 2/16/82; am and ren §18-235-7-01 12/8/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-7)

HRS §235-7(a)(2) **§18-235-7-02 Exclusion of benefits under public retirement systems.** (a) The rules in this section shall be coordinated with provisions of the IRC. The IRC is operative in chapter 235, HRS, pursuant to sections 235-2.3 to 235-2.4, HRS, and other HRS provisions. To determine the taxability for state purposes of a distribution from a public retirement system, the taxpayer must first determine the federal income tax treatment for a distribution from such public retirement system. If a distribution from such public retirement system is not subject to federal income taxation, the distribution is similarly exempt from state income taxation under section 235-2.3 or 235-2.4, HRS. If, however, the distribution is partially or totally subject to income taxation under section 235-2.3 or 235-2.4, HRS, the taxpayer may turn to section 235-7(a)(2), HRS, and this section to determine whether the taxpayer is able to claim a total or partial exemption for such taxable portion of the distribution, as the case may be.

(b) Section 235-7(a)(2), HRS, excludes from gross income, adjusted gross income, and taxable income, any right, benefit, and other income exempted from taxation by section 88-91, HRS, and comparable rights, benefits, and other income under any other public retirement system.

(c) As used in this section, "governmental plan" means a plan established and maintained for its employees by the United States, any state, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, any foreign country, any political subdivision of any of the foregoing, or any agency or instrumentality of any of the foregoing. In interpreting this term, the department shall follow Internal Revenue Service interpretations of section 414(d) (with respect to definition of governmental plan), Internal Revenue Code of 1986, including Rev. Rul. 89-49, 1989-1 C.B. 117.

Example: T is a faculty member at W University, a university that is an instrumentality of the State of Washington. T participates in a pension fund established with F, a company selling annuity contracts nationwide. F is not affiliated with or controlled by the State of Washington. The pension fund in which T participates is not maintained by a government or agency or instrumentality thereof. That pension fund is not a governmental plan.

(d) Gross income does not include benefits paid by the State of Hawaii Employees' Retirement System that are described in section 88-91, HRS, benefits paid by the United States Government under the Civil Service Retirement Act, 5 U.S.C. §§8331 et seq., or any comparable benefits paid by a governmental plan. Benefits shall be presumed to be comparable to those described in section 88-91, HRS, if similar benefits paid by a plan other than a governmental plan would qualify for exclusion under section 235-7(a)(3), HRS, and section 18-235-7-03.

(e) The exclusion provided by section 235-7(a)(2), HRS, does not apply to benefits attributable to voluntary contributions made by an employee of a government employer under an elective right.

Example: The State of Hawaii Deferred Compensation Plan described in chapter 88E, HRS, is a plan described in section 457 (with respect to deferred compensation plans of state and local governments and tax exempt organizations), IRC. Pursuant to section 88E-2, HRS, and section 457(b), IRC, participation in the plan is by written agreement between the employee and the employing government agency, and thus is voluntary. Benefits paid by the plan are not excluded from gross income under section 235-7(a)(2), HRS.

(f) Benefits from a governmental plan that are transferred between plans on a nontaxable basis, including amounts paid into a rollover individual retirement account, shall retain their character as benefits from a governmental plan. [Eff 2/16/82; am and ren §18-235-7-02 12/8/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-7)

HRS §235-7(a)(3) **§18-235-7-03 Exclusion of pension income.** (a) The rules in this section shall be coordinated with provisions of the IRC. The IRC is operative in chapter 235, HRS, pursuant to sections 235-2.3, 235-2.4, HRS, and other HRS provisions. To determine the taxability for state purposes of a distribution from a pension, profit sharing, or similar plan, the taxpayer must first determine the federal income tax treatment for a distribution from such plan. If a distribution from such plan is not subject to federal income taxation, the distribution is similarly exempt from state income taxation under section 235-2.3 or 235-2.4, HRS. If, however, the distribution is partially or totally subject to income taxation under section 235-2.3 or 235-2.4, HRS, the taxpayer may turn to section 235-7(a)(3), HRS, and this section to determine whether the taxpayer is able to claim a total or partial exemption for such taxable portion of the distribution, as the case may be. In determining whether the taxpayer is eligible to claim an exemption for a distribution under section 235-7(a)(3), HRS, and this section, section 235-7(a)(3) does not adopt the provisions in Subchapter D of the IRC (sections 401 through 424, IRC) which redefine certain amounts as employer contributions, and artificially redefine self-employed persons as employees, for purposes of those IRC sections. If the distribution is subject to income taxation in whole or in part under section 235-7(a)(3), HRS, and this section, the taxpayer shall include the taxable amount of such distribution in determining the taxpayer's gross income, adjusted gross income, and taxable income.

(b) Section 235-7(a)(3), HRS, excludes from gross income, adjusted gross income, and taxable income, any compensation received in the form of a pension for past services.

(c) As used in this section:

"By reason of retirement, disability, or death" describes benefits paid because of retirement, including attainment of age 70-1/2 (to comply with section 401(a)(9)(C), IRC, with respect to required beginning date); disability as defined in section 72(m)(7) (with respect to meaning of "disabled"), IRC; or death. A benefit payment is not made by reason of retirement, disability, or death if it is actually or constructively received prior to retirement, disability, or death, even though the benefit payment is the same as the amount of benefits which would have been enjoyed upon retirement. A payment made by reason of retirement, disability, or death does not include:

(1) An amount paid because of separation from service before retirement;
(2) An employer contribution to a non-qualified pension plan that is deemed to be received by the employee upon vesting before retirement under Treas. Reg. §1.402(b)-1(b) (with respect to taxability of employee when rights under nonexempt trust change from nonvested to vested); or
(3) An early distribution subject to federal penalty tax under section 72(t) (with respect to 10 per cent additional tax on early distributions from qualified retirement plans), IRC.

"Employer contribution" means the aggregate amount of contributions that are either made by the employer, or made for the employer by members of a group of affiliated corporations as provided by section 404(a)(3)(B) (with respect to profit sharing plan of affiliated group), IRC. These amounts are included in the employer contribution even though section 72(f) (with respect to special rules for computing employees' contributions) or 101(b) (with respect to employees' death benefits), IRC, may provide that the amounts are considered employee contributions for some purposes. The employer contribution does not include any amounts included in pretax employee contribution or previously taxed contribution. Employer contribution does not include any amounts contributed by a plan beneficiary under an elective right, provided that an amount otherwise qualifying as an employer contribution shall not be disqualified as to a particular beneficiary solely because (1) the beneficiary determined the contribution amount in his or her capacity as an officer, partner, member, or sole proprietor, or (2) the beneficiary is allowed or is allocated all or a portion of the deduction allowable under section 162 or 404, IRC, attributable to the contribution.

"Exclusion ratio" means the ratio described in subsection (e)(1).

"Pension." A pension:

(1) Provides an employee with compensation for past services, generally measured by such factors as years of employees' service and compensation received;
(2) May be in the form of a (A) periodic or systematic payment of benefits to the employee over a period of years (e.g., usually for life after retirement), or (B) lump sum in lieu of periodic or systematic payments;
(3) Is to be received by the employee by reason of retirement, disability, or death;
(4) Is attributable to employer contribution;
(5) Includes a stock bonus, pension, profit sharing, or annuity plan, as those terms are defined in sections 401 (with respect to qualified pension, profit sharing, and stock bonus plans) and 403 (with respect to taxation of employee annuities), IRC;

(6) Need not be qualified within the meaning of section 401, IRC; and

(7) May be paid to the employee, the employee's spouse upon retirement or disability, or a deceased employee's beneficiary.

"Pretax employee contribution" means the aggregate amount of voluntary contributions made by the employee under any elective right, such as contributions to: (1) individual retirement accounts to which an employer does not contribute (see subsection (d)(2) for rollover individual retirement accounts), (2) IRC section 401(k) plans (with respect to cash or deferred arrangements); (3) IRC section 408(k)(6) plans (with respect to elective salary reduction contributions to simplified employee pension arrangements), or (4) IRC section 457 plans (with respect to deferred compensation plans of state and local governments and tax exempt organizations); but it does not include previously taxed contribution. These amounts are included in the pretax employee contribution even though the IRC may provide that the amounts are considered employer contributions for some purposes.

"Previously taxed contribution" means the aggregate amount of contributions that:

(1) Were included in the employee's gross income under the Hawaii Income Tax Law, whether or not Hawaii income tax was actually due or paid; or

(2) Would not have been includable in gross income under the Hawaii Income Tax Law applicable at the time of contribution if the employee were a Hawaii resident and the contributions were paid directly to the employee at the time.

Previously taxed contribution includes amounts included in the gross income of an employee under section 402(b) (with respect to taxability of beneficiary of nonexempt trust) or 403(c) (with respect to taxability of beneficiary under nonqualified annuities or under annuities purchased by exempt organizations), IRC.

(d) The following rules shall be used to determine previously taxed contribution, employer contribution, and pretax employee contribution.

(1) The employer and employee shall be assumed to be Hawaii residents throughout the period of employment, regardless of their actual residence.

(2) Amounts transferred between plans on a nontaxable basis, including amounts paid into a rollover individual retirement account, shall retain their character, as between employer contribution, pretax employee contribution, and previously taxed contribution.

(3) Interim distributions, such as payments made to a spouse or former spouse pursuant to an order described in section 414(p) (relating to qualified domestic relations orders), IRC, hardship withdrawals, and any other early distributions, shall be disregarded in computing the exclusion ratio in subsection (e)(1).

(4) Amounts treated as a refund of the consideration paid under section 72(c)(2) (with respect to adjustment in investment where there is refund feature), IRC, shall be subtracted from previously taxed contribution.

(5) Previously taxed contribution includes amounts attributable to life insurance protection under Treas. Reg. §1.72-16(b) (with respect to treatment of cost of life insurance protection) that are included in the employee's gross income at the time of contribution.

(e) The methods set forth in this subsection shall be used to determine the portion of the amount that is attributable to the employer contribution. These methods shall be applied separately for each pension from which an amount is received.

(1) The exclusion ratio shall be the employer contribution divided by the sum of the employer contribution, previously taxed contribution, and the pretax employee contribution.

(2) The exclusion ratio shall be computed as of the first day of the first period for which an amount is received as an annuity, or, if the benefit involved is not an annuity, the date when the employee or beneficiary of the employee becomes eligible for the payment by reason of death, disability, or separation from service.

(3) The life expectancy of the employee or beneficiary shall be determined using either (A) the methods set forth in section 72(c)(3) (with respect to expected return), IRC, and Treas. Reg. §1.72-5 (with respect to expected return), or (B) the safe harbor method of Internal Revenue Service Notice 88-118, 1988-2 C.B. 450. Once a method is chosen, it must be used for all purposes of chapter 235, HRS, requiring a determination of life expectancy or expected return, and it must be used consistently between taxable years.

Example 1: Under the terms of an exempt employees' pension trust Mr. Andrade has $4,000 of previously taxed contribution and the employer has contributed $6,000. Upon retirement on January 1, 1991, Mr. Andrade is entitled to receive $1,200 a year for the remainder of his life, and he receives $1,200 in 1991. The exclusion ratio is the employer contribution of $6,000 divided by the sum of $6,000 (the employer contribution), the pretax employee contribution of zero in this example, and previously taxed contribution of $4,000. Thus the exclusion ratio is $6,000 / $10,000

or 60 per cent. Hence, 60 per cent of $1,200, or $720, is excluded in 1991 under section 235-7(a)(3), HRS.

Assume that Mr. Andrade's life expectancy determined under this paragraph is ten years. Under applicable federal principles, the $4,000 of previously taxed contribution is prorated over Mr. Andrade's expected life, yielding $4,000 / 10 years = $400 per year. Thus, an additional $400 is excluded in 1991 as the return of previously taxed income. The remaining $80 is included in gross income.

(4) In the case of an annuity, the exclusion ratio, once determined, shall continue to apply to each annuity payment whether or not the cumulative amount excluded under section 235-7(a)(3), HRS, exceeds the employer contribution. If, after a taxpayer's death, neither the taxpayer nor the taxpayer's beneficiary fully recover the employer contribution from a pension, section 235-7(a)(3), HRS, does not permit any additional deduction or exclusion of the unrecovered amount.

Example 2: The facts are the same as in Example 1. In 1992 and subsequent years, 60 per cent of each $1,200 payment shall be excluded regardless of how long Mr. Andrade actually lives.

Mr. Andrade actually dies in late 1995, after receiving $1,200 from the annuity payor in that year. Under the terms of the annuity, the payor has no further liability to make payments to Mr. Andrade or his beneficiary. Mr. Andrade's estate is allowed a deduction on Mr. Andrade's income tax return for 1995 for his unrecovered investment in the annuity under section 72(b)(3) (with respect to deduction where annuity benefits cease before the entire investment is recovered) IRC, as operative under chapter 235, HRS. His estate also is allowed to exclude 60 per cent of the $1,200 paid to Mr. Andrade in 1995 while he was alive, as well as the $400 in previously taxed contribution attributable to that payment, but no further deduction or exclusion for the unrecovered employer contribution is allowed under section 235-7(a)(3), HRS.

(5) If property (such as shares of stock) is distributed as a pension instead of money, the distributee's basis in the property shall be increased by the exclusion under section 235-7(a)(3), HRS, upon distribution of the property. The exclusion under section 235-7(a)(3), HRS, does not apply to dividends or other income produced by the property after distribution.

Example 3: Under the terms of an exempt profit sharing plan Ms. Bicoy, an employee, has contributed $4,000 and her employer has contributed $6,000, all while Ms. Bicoy was working in New York. The plan does not accept after-tax contributions from employees. Upon retirement on January 1, 1993, Ms. Bicoy moves to Hawaii and the plan distributes 12 shares of ABC Co. common stock to her. At the time the 12 shares are distributed in 1993, the stock is worth $100 a share, for a total distribution of $1,200. The exclusion ratio is the employer contribution of $6,000 divided by the sum of $6,000 (the employer contribution), the pretax employee contribution of $4,000, and previously taxed contribution of zero in this example. Thus the exclusion ratio is $6,000 / $10,000 or 60 per cent. Hence, $720 is excluded in 1993 under section 235-7(a)(3), HRS, and the remaining $480 is included in 1993 gross income because Ms. Bicoy has no previously taxed contribution. Ms. Bicoy's basis in the 12 shares of ABC Co. common stock distributed to her would be $480 but for this section. Her basis in the stock is increased by $720, to $1,200.

In 1994, the plan distributes to Ms. Bicoy 12 additional shares of ABC Co. common stock, which are then worth $1,500. In 1994, 60 per cent of $1,500, or $900, is excluded under section 235-7(a)(3), HRS, and the remaining $600 is included in her 1994 gross income. The basis of the second 12 shares of ABC Co. common stock in the hands of Ms. Bicoy is increased by $900, to $1,500. The basis of her first 12 shares remains $1,200, and any dividends paid on any shares after distribution to Ms. Bicoy are fully taxable to her.

(6) In order to be entitled to the exclusion under section 235-7(a)(3), HRS, the taxpayer bears the burden of proof in establishing the amount of previously taxed contribution and employer contribution. However, where the amount of employer contribution is not determinable the following alternative method may be used:

(A) Compute the present discounted value of the payments being made to the employee, as of the payment starting date. The employee's life expectancy shall be determined under paragraph (3). The interest rate used shall be the rate paid on tax refunds as specified in section 231-23, HRS (8 per cent since January 1, 1968).

(B) Determine the future value of all amounts included in previously taxed contribution and pretax employee contribution, as of the payment starting date, using the following assumptions:

(i) The interest rate shall be the rate paid on tax refunds as specified in section 231-23, HRS.

(ii) The amounts were paid at the time of contribution. Amounts that are contributed by an employer but are later included in the employee's gross income shall be considered paid at the time they are included in income.

(iii) In computing the interest, the compounding interval shall be the most frequent interval between contributions, but shall not be longer than one year.

(C) Subtract the total of the amounts in (B) from the amount in (A).

(D) The ratio of (C) to (A) shall be used as the exclusion ratio.

Example 4: Under the terms of a qualified defined benefit plan Mr. Corpuz, a male employee aged 66, is entitled to receive $500 a month for the rest of his life beginning on his retirement date of January 1, 1994. He is unable to determine how much his employer contributed, but he contributed $150 a month in pretax income for the past 120 months. Mr. Corpuz has no previously taxed contribution in the plan. Assuming that Mr. Corpuz uses the method of Treas. Reg. §1.72-5, calculation of the excluded amount is as follows. (A) The expected return multiple in Table V of Treas. Reg. §1.72-9 corresponding to Mr. Corpuz' age is 19.2. Thus, Mr. Corpuz is expected to live 19.2 years, or 12 x 19.2 = 230.4 months. The present value of $500 a month for 230.4 months, discounted at 8 per cent a year, is $58,774. (B) The value of the pretax employee contributions is the future value, as of the annuity starting date, of $150 a month for 120 months at 8 per cent a year, or $27,442. There was no previously taxed contribution. (C) The employer contribution is assumed to be $58,774 - $27,442 = $31,333. (D) The exclusion ratio is $31,333 / $58,774 = 53.3 per cent. Thus 53.3 per cent of every $500 payment, or $267 a month, is considered to be a pension excludable under section 235-7(a)(3), HRS.

Example 5: Upon retirement, Mrs. Doo, age 65, begins receiving retirement benefits in the form of a joint and 50 per cent survivor annuity to be paid for the joint lives of Mrs. Doo and her spouse, age 59. Mrs. Doo's annuity starting date is January 1, 1988. Mrs. Doo is unable to determine how much her employer contributed, but she contributed $50 with each semimonthly paycheck for the past 20 years, totaling $24,000. Her company's retirement plan does not accept pretax employee contributions. Mrs. Doo was paid twice a month. Mrs. Doo will receive a retirement benefit of $1,000 a month, and her spouse will receive a survivor benefit of $500 a month upon Mrs. Doo's death. (A) Assume Mrs. Doo uses the method in Internal Revenue Service Notice 88-118, 1988-2 C.B. 450. Under that method, the set number of monthly payments for a distributee who is age 65 is 240. That figure also applies to a survivor annuity. The present value of $1,000 a month for 240 months, discounted at 8 per cent a year, is $119,554. (B) The value of the previously taxed contributions is the future value, as of the annuity starting date, of $50 twice a month for 480 semimonthly periods at 8 per cent a year, or $59,098. The pretax employee contribution is zero. (C) The employer contribution is assumed to be $119,554 -$ 59,098 = $60,456. (D) The exclusion ratio is $60,456 / $119,554 = 50.6 per cent. Thus 50.6 per cent of every $1,000 payment, or $506 a month, is considered to be a pension excludable under section 235-7(a)(3), HRS. When Mrs. Doo dies, 50.6 per cent of every $500 payment to her spouse, or $253 a month, is considered a pension excludable under section 235-7(a)(3), HRS, regardless of how long her spouse lives.

In addition, $100 ($24,000 / 240 payments) of each payment to either Mrs. Doo or her spouse is excluded from gross income as a return of capital, under federal rules, until 240 payments have been made to either Mrs. Doo or her spouse.

(7) If the exclusion of section 101(b) (with respect to employees' death benefits), IRC, applies, an additional computation shall be made to prevent double exclusion.

(A) If an annuity is paid by reason of the death of an employee, the amount of the section 101(b) exclusion is applicable only to forfeitable amounts under section 101(b)(2)(B), IRC, and thus is allocable solely to the employer's contribution. The section 101(b) exclusion shall be prorated over the expected return of the annuity, and the prorated amount shall be subtracted from the amount otherwise excludable as a pension.

(B) If the section 101(b) exclusion applies to a lump sum, the section 101(b) exclusion shall be allocated among all amounts other than previously taxed contribution, and the amount of the section 101(b) exclusion allocable to the employer contribution shall be subtracted from the amount otherwise excludable as a pension.

Example 6: Under the terms of an exempt employee's pension trust, a beneficiary of an employee who dies before reaching retirement age is entitled to receive $1,200 a year for 10 years. Under the terms of the trust, no other benefits are paid to any other beneficiary or to the estate of the deceased employee. Mr. Esaki, an employee, died in January, 1992, before reaching retirement age, and his beneficiary, his daughter Chelsea, receives $1,200 in 1992. As of the date of his death, Mr. Esaki had $4,000 of previously taxed contribution, and his employer had contributed $6,000. If Mr. Esaki had quit in January, 1992, he would have received $5,000 from the trust. Assume that Chelsea is entitled to a death benefit exclusion of $5,000 under section 101(b), IRC.

As in Example 1, the exclusion ratio is 60 per cent. Thus, of the $1,200 Chelsea received in 1992, 60 per cent, or $720, would be excluded as a pension absent the section 101(b) exclusion. However, the section 101(b) exclusion amount allocable to 1992, namely $5,000 / 10 years = $500, is subtracted. The remaining $220 is the amount excluded under section 235-7(a)(3), HRS. Under applicable IRC principles (section 101(b)(2)(D), IRC, relating to annuities other than joint and survivor annuities), the $5,000 is treated as an additional contribution of previously taxed income. Because $900 a year ($4,000 + $5,000, divided by 10 years) is excluded as a return of capital, an additional $900 is excluded in 1992. The remaining amount, $1,200 - $220 - $900 = $80, is included in gross income.

Example 7: The facts are the same as in Example 6, except that the beneficiary of an employee who dies before reaching retirement age is entitled to receive $12,000 payable in a lump sum. Thus, Chelsea receives $12,000 in 1992.

As in Example 6, the exclusion ratio is 60 per cent. Thus, $7,200 is allocable to the employer contribution and would be excluded under section 235-7(a)(3), HRS, but for section 101(b), IRC. Under this paragraph, the $5,000 exclusion applies to all amounts other than the previously taxed contribution of $4,000, which total $12,000 -$ 4,000, or $8,000. The proportion of the $5,000 allocable to the employer contribution is thus ($7,200/$8,000) x $5,000, or $4,500. This amount is subtracted from the $7,200, yielding $2,700. The amount of $2,700 is excluded under section 235-7(a)(3), HRS.

Under applicable IRC principles, two additional amounts are excluded: the $5,000 under section 101(b), IRC, and the $4,000 as a return of previously taxed income. The remaining $300 is included in gross income. [Eff 2/16/82; am and ren §18-235-7-03 12/8/94, am 1/1/98] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-7)

Historical note: §18-235-7-03 is based substantially upon §18-235-7(a)(3). [Eff 2/16/82; am and ren §18-235-7-03 12/8/94]

§18-235-7-04 to §18-235-7-14 (Reserved)

HRS §235-7(d) **§18-235-7-15 Net operating loss deduction.** (a) No net operating loss shall be carried back to any taxable year ending prior to January 1, 1967, as provided by section 235-7(d)(2), HRS.

(b) In computing the net operating loss to be carried back or carried over, there shall be included in gross income the amount of interest which is excluded from gross income by section 235-7(a), HRS, decreased by the amount of interest paid or accrued which is disallowed as a deduction by section 235-7(e), HRS.

(c) A net operating loss carryback shall be limited to three taxable years preceding the taxable year of such loss.

(d) A net operating loss carryover shall be limited to fifteen taxable years following the taxable year of such loss.

(e) In computing the net operating loss, deductions shall be allowed only to the extent they are connected with and allocable to income taxable in this State under section 235-5, HRS, and section 265 (with respect to expenses and interest relating to tax-exempt income), IRC, as operative under chapter 235, HRS.

(f) A taxpayer's election under section 172(b)(3)(C) (with respect to election to waive carryback), IRC, as operative under chapter 235, HRS, does not extend the net operating loss carryover period beyond fifteen taxable years following the taxable year of such loss.

No taxpayer shall make such an election as to a net operating loss of a business where the net operating loss occurred in the taxpayer's business prior to the taxpayer entering business in this State. The election is made by attaching a statement to that effect to the taxpayer's return (or amended return) for the taxable year of the loss, and must be made no later than the due date of the return (including extensions) for that year.

(g) A refund of Hawaii income tax resulting from a net operating loss carryback is properly included in the gross income of a taxpayer using the accrual method of accounting for the taxable year of the loss which gives rise to the refund.

(h) A deficiency attributable to the application to the taxpayer of a net operating loss carryback may be assessed at any time before the expiration of the period within which a deficiency may be assessed for the taxable year of the net operating loss which results in the carryback.

(i) For rules governing when a claim for credit or refund attributable to a net operating loss carryback may be filed, see section 235-111(d), HRS, and section 18-235-111(a)(2).

(j) For corporations that have elected or are electing under subchapter S, IRC, as operative under chapter 235, HRS:

(1) No carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which the corporation is an S corporation, except as provided in section 235-125.5, HRS.

(2) No carryforward, and no carryback, shall arise at the corporate level for a taxable year for which the corporation is an S corporation, pursuant to section 235-7(d)(3), HRS, and section 1371(b)(2), IRC.

(3) Nothing in paragraph (1) or (2) shall prevent treating a taxable year for which the corporation is an S corporation as a taxable year for purposes of subsections (c) and (d). [Eff 2/16/82; am and ren §18-235-7-15 12/8/94] (Auth: HRS §§231-3(9), 235-2.5(b), 235-118) (Imp: HRS §§235-7, 235-111)

Historical note: §18-235-7-15 is based substantially upon §18-235-7(d). [Eff 2/16/82; am and ren §18-235-7-15 12/8/94]

§18-235-8 to 18-235-11 (Reserved)

HRS §235-12

§18-235-12 Solar energy devices; income tax credit. (a) Definitions. As used in section 235-12, HRS:

"Cost of the device" means the amount paid by the taxpayer minus the fair market value of merchandise, gift, or other items of value received, if any, as part of the purchase contract. Cost when used in reference to the acquisition of materials or services refer to the invoice price directly related to the solar energy device and does not include indirect cost such as replacing existing water heaters, plumbing, wiring, etc. Also labor, materials and components which will serve a significant structural function in the dwelling (e.g. extra-thick walls, supports, etc.) shall not be eligible for the credit.

(b) Claim for credit.

(1) Credit shall be claimed for the year the new solar energy device was purchased and placed in use in this State. However, where separate taxable years are involved where the device is purchased in one year and placed in use in another year, the credit shall be allowed in the year placed in use. (After December 31, 1974, but before December 31, 1981.)

(2) The claim for tax credit, not to exceed ten per cent of the total cost of the device, shall be against the income tax liability and any remaining credit may be carried forward and used in subsequent taxable years until exhausted. The claim shall contain the necessary information provided for on the form and shall be attached to the income tax return in the year first placed in use and subsequent taxable years for carrying forward the remaining credit. The forms provided are:

N-157	Individual taxpayer;
N-157-A	Taxpayers who are members of a partnership, estate or trust, or small business corporation; and
N-306	Corporation

(3) Taxpayer shall maintain proper supporting documents to substantiate the cost of the device for the period the claim remains valid, and upon request shall submit such documents to the department of taxation.

Example 1: Taxpayer purchased a new home which included solar energy hot water system for $100,000. Of this total, the land was valued at $50,000 and the house at $50,000. According to estimates provided by the taxpayer, the same home built without the solar energy hot water system would cost $45,000, a difference of $5,000. This amount of $5,000 would be the basis for the ten per cent credit, thus $500 is the maximum amount of credit that may be applied against the tax liability.

Example 2: Taxpayer purchased a solar energy hot water system for his home. The total cost of the system was quoted at $3,500. Structural reinforcements to the roof and new electrical wiring necessary for the installation of the solar energy system increased the total cost to $5,000. In spite of the foregoing increase in cost to $5,000, only $3,500 which was the cost of the system qualifies for the tax credit. Thus the 10 percent allowable credit would be $350. [Eff 2/16/82] (Auth: HRS §§231-3(9), 235-12, 235-118) (Imp: HRS §235-112)

HRS §235-12.2 **§18-235-12.2 Energy conservation devices for hot water heaters; income tax credit.** (a) Limitation of credit. Section 235-12.2, HRS, provides a tax credit against the tax imposed by chapter 235, HRS, to resident individuals and corporations who have installed energy conservation devices for hot water heaters.

(b) Claim for credit.

(1) Credit shall be claimed for the year the insulation material was purchased and installed in this State. Hence, where the insulation material is purchased in one year and installed in another, the credit shall be allowed in the year of installation. (After 12/31/77 but before 12/31/84.)

(2) The claim for tax credit, not to exceed $30.00 shall be claimed against the income tax liability and any remaining credit shall be carried forward and used in subsequent taxable years until exhausted. The claim shall contain the necessary information provided for on the form and shall be attached to the income tax return in the year first installed and subsequent taxable years for which a tax credit is claimed. The forms provided are:

N-159	Individual taxpayer;
N-159-A	Taxpayers who are members of a partnership, estate or trust, or small business corporation; and
N-307	Corporation

(3) Taxpayer shall maintain proper supporting documents to substantiate the cost of the energy conservation device for the period the claim remains valid and upon request shall submit such documents to the department of taxation. [Eff 2/16/82] (Auth: HRS §§231-3(9), 235-12.2, 235-118) (Imp: HRS §235-12.2)

HRS §235-12.5 **§18-235-12.5-01 Definitions.** (a) As used in section 235-12.5, HRS, and sections 18-235-12.5-01 through 18-235-12.5-05:

(1) "Actual cost" means the amounts incurred or paid for renewable energy technology systems under section 235-12.5(a), HRS, including peripheral equipment ordinarily and necessarily required for system operation and installation. Actual cost shall not include any consumer incentive payments or premiums offered with the system, regardless of when such payment or premium is made to the customer, and shall not include any amount for which another credit is claimed under chapter 235, HRS. Any amounts incurred or paid for the repair, construction, or reconstruction of a structure or building in conjunction with the installation and placing in service of a solar or wind energy system shall not constitute a part of actual cost for the purposes of section 235-12.5, HRS.

(2) "Commercial property" means a property which cannot be properly characterized as residential or mixed-use property. A hotel, or any other place in which lodgings are regularly furnished to transients for consideration, in which all of the rooms, apartments, suites, or the like are occupied by a transient for less than one hundred eighty consecutive days for each letting will be considered commercial property to the extent of that use.

(3) "Installed and placed in service" means that the system is ready and available for its specific use. With respect to systems installed for residential property, all requirements will be completed and a system will be deemed to be installed and placed in service when: (1) The actual cost has been incurred; (2) all installation, including all related electrical work, has

been completed; and (3) any required requests for inspection of the installation has been received by the appropriate government agency. However, if the residential installation fails to pass all the required inspections the credit is properly claimed in the taxable year in which the system passes such inspection.

(4) "Mixed-use property" means a property on which at least one residence exists and commercial activity takes place.

(5) "Multi-family residential property" means a property on which more than one residence is located. The determination that property is multi-family residential property is fact specific, but in general and in the absence of other relevant facts to the contrary, multi-family residential property will be real property that is described in a recorded title and that has more than one mailing address or separate entrances to separate living areas. The following exceptions may apply:

(A) The Ohana House Exception: If a single property has two separate residences, each occupied by members of a family as defined in the Internal Revenue Code, section 267(b)(1), then each residence will be considered a separate single-family residential property if the system services both residences. Partners in a civil union will also be considered members of a family for the purpose of this exception; or

(B) The Directed Use Exception: If a system only services one residence on a multi-family residential property, then the system will be treated as servicing a single-family residential property.

(6) "Property" means a single, definable portion of real property located in the State as described in a title recorded with the Bureau of Conveyances or Land Court of the state of Hawaii and that the applicable law allows to be sold in fee simple separately from any other real property located in the State. For purposes of the Renewable Energy Technologies Income Tax Credit under section 235-12.5, HRS, all such titled property in the State is to be characterized as commercial, residential, or a mix of the two (mixed-use). When special circumstances exist, the department, at its discretion, may determine whether an interest qualifies as a "property" for the purposes of the credit on a case-by-case basis.

(7) "Renewable energy technology system" means a new system that captures and converts a renewable source of energy, such as solar or wind energy, into a usable source of thermal or mechanical energy, electricity, or fuel.

(8) "Residence" means dwelling place or place of habitation, an abode.

(9) "Single-family residential property" means a property on which one residence is located.

(10) "Standard Test Conditions" means 25 degrees Celsius cell/module temperature, 1,000 watts per square meter (W/m^2) irradiance, air mass 1.5 (AM 1.5) spectrum.

(11) "Total output capacity" means the combined individual output capacities (maximum power) of all identifiable facilities, equipment, apparatus or the like that make up the renewable energy technology system installed and placed in service during a taxable year measured in kilowatts. The total output capacity of a solar energy system shall be calculated using the manufacturer's published specifications of the components of the solar energy system. Generally, for photovoltaic solar energy systems, total output capacity is the output capacity (maximum power) of each cell, module or panel at Standard Test Conditions in kilowatts multiplied by the number of cells, modules or panels installed and placed into service during a taxable year. The amount of energy actually produced is not relevant to calculating total output capacity. [Eff 1/02/14] (Auth: HRS §§231-3(9), 235-12.5, 235-118) (Imp: HRS §235-12.5)

§18-235-12.5-02 (Reserved)

HRS §235-12.5 **§18-235-12.5-03 Other Solar Energy Systems.** (a) "Solar energy system" means any identifiable facility, equipment, apparatus, or the like that converts solar energy to useful thermal or electrical energy for heating, cooling, or reducing the use of other types of energy that are dependent upon fossil fuel for their generation. Unless subsection (b) applies, each solar energy system installed and placed in service on or after January 1, 2013 shall have a total output capacity at Standard Test Conditions as follows:

(1) Single-family residential property: For credits calculated under section 235-12.5(a)(1), HRS, and capped under section 235-12.5(b)(2)(A), HRS, each system for which a credit is claimed shall have a total output capacity of at least 5 kilowatts.

(2) Multi-family residential property: For credits calculated under section 235-12.5(a)(1), HRS, and capped under section 235-12.5(b)(2)(B), HRS, each system for which a credit is claimed shall have a total output capacity of at least 0.360 kilowatts per unit per system.

(3) Commercial property: For credits calculated under section 235- 12.5(a)(1), HRS, and capped under section 235-12.5(b)(2)(C), HRS, each system for which a credit is claimed shall have a total output capacity of at least 1,000 kilowatts.

Example 1: Taxpayer installs and places into service solar energy equipment including 20 photovoltaic panels, each of which has an output capacity (maximum power) of 0.250 kilowatts on a single-family residential property. The installation has a total output capacity of 5 kilowatts (0.250 kilowatts times 20 photovoltaic panels). One system has been installed and placed into service for the purpose of calculating the credit. The actual cost of the system may not be divided in order to claim multiple credits because the solar energy system only meets the total output capacity requirement for one system.

Example 2: Taxpayer installs and places into service solar energy equipment including 40 photovoltaic panels, each of which has an output capacity (maximum power) of 0.180 kilowatts on a multi-family residential property. The installation has a total output capacity of 7.2 kilowatts (0.180 kilowatts times 40 photovoltaic panels). If the installation serves 20 units, the total output capacity for each system must be at least 7.2 kilowatts (0.360 kilowatts times 20 units). One system has been installed and placed into service for the purpose of calculating the credit.

Example 3: Taxpayer installs and places into service solar energy equipment including 4,000 photovoltaic panels, each of which has an output capacity (maximum power) of 0.250 kilowatts on a commercial property. The installation has a total output capacity of 1,000 kilowatts (0.250 kilowatts times 4,000 photovoltaic panels). Since each system must have a total output capacity of at least 1,000 kilowatts, one system has been installed and placed into service for the purpose of calculating the credit.

Example 4: Taxpayer installs and places into service solar energy equipment including 40 photovoltaic panels, each of which has an output capacity (maximum power) of 0.250 kilowatts on a single-family residential property. The installation has a total output capacity of 10 kilowatts (0.250 kilowatts times 40 photovoltaic panels). Since each system must have a total output capacity of at least 5 kilowatts, two systems have been installed and placed into service for the purpose of calculating the credit.

Example 5: During March of a taxable year, Taxpayer installs and places into service solar energy equipment including 10 photovoltaic panels, each of which has an output capacity (maximum power) of 0.250 kilowatts on a single-family residential property. During August of the same taxable year, Taxpayer installs and places into service additional equipment including 10 photovoltaic panels, each of which also has an output capacity (maximum power) of 0.250 kilowatts on the same the single-family residential property. The total output capacity of both installations is 5 kilowatts [(0.250 kilowatts times 10 photovoltaic panels) + (0.250 kilowatts times 10 photovoltaic panels)] because the output capacity of both installations must be combined. Since each system must have a total output capacity of at least 5 kilowatts, one system has been installed and placed into service for the purpose of calculating the credit.

(b) The credit may be claimed for one solar energy system installed and placed in service per property which fails to meet the applicable total output capacity requirement as set forth in subsections (a)(1) through (a)(3), where:

(1) Only one solar energy system, for the purposes of the credit, has been installed and placed in service during a taxable year on a single property; or

(2) More than one solar energy system, for the purposes of the credit, has been installed and placed in service during a taxable year on a single property and one of the systems fails to meet the applicable total output capacity requirement.

Example 6: Taxpayer installs and places into service solar energy equipment including 10 photovoltaic panels, each of which has an output capacity (maximum power) of 0.250 kilowatts on a single-family residential property. The installation has a total output capacity of 2.5 kilowatts (0.250 kilowatts times 10 photovoltaic panels). Although the system does not meet the total output capacity requirement, subsection (b)(1) permits the claiming of the credit because only one system has been installed and placed into service on one property.

Example 7: Taxpayer installs and places into service solar energy equipment on a single-family residential property which has a total output capacity of 7.5 kilowatts and an actual cost of $37,500. In order to calculate the credit, the actual cost per kilowatt must be determined by dividing the actual cost by the total output capacity. The actual cost per kilowatt is $5,000 ($37,500 divided by 7.5 kilowatts). Since a system installed and placed in service on a single family residential property must have a total output capacity of at least 5 kilowatts, the actual cost of the first system is $25,000 ($5,000 times 5 kilowatts). The credit for the first system is $5,000 because thirty-five percent of $25,000 exceeds the applicable cap of $5,000. A credit for the second system may also be claimed because subsection (b)(2) permits taxpayers to claim the credit for one system per property that fails to meet the total output capacity requirement. The actual cost of the second system is $12,500 ($5,000 times 2.5 kilowatts). The credit for the second system is $4,375 or thirty-five percent of $12,500. [Eff 1/02/14] (Auth: HRS §§231-3 (9), 235-12.5, 235-118) (Imp: HRS §235-12.5)

§18-235-12.5-04 (Reserved)

HRS §235-12.5 **§18-235-12.5-05 Multiple Properties and Mixed use Property.** (a) Property will be considered residential or mixed-use if any portion of the property is being used as a residence. If at the time of installation and placing in service of the system the property is not occupied, then property will be considered residential or mixed-use if any portion of the property is intended for use as a residence.

(b) Allocation. Where a single system is installed and placed in service to serve more than one property or to service a mixed-use property the taxpayer shall apply a reasonable allocation method such as square footage or a measure of use as follows:

(1) For a system installed and placed in service to serve more than one property, the actual cost of a single system servicing multiple properties is allocated among the properties. The actual cost of other solar energy systems shall be allocated in a manner consistent with section 18-235-12.5-03. With multiple properties, the appropriate cap is applied for each separate property.

Example 1: Assume Taxpayer installs and places into service a wind farm that services one community of 50 single-family homes and 10 separate commercial properties. Each property is equal in size and use, the allocation of the actual cost would be made equally to each property. Further assume that a $600,000 wind powered system were installed and placed in service for these properties, the credit would be calculated as follows: Allocation of cost: The actual cost of $600,000 would be divided equally among the properties, allocating $10,000 to each property. Single-family residential: Each single family residential property would be treated independently. In each case, twenty percent of $10,000, or $2,000, would be compared against the $1,500 single-family residential property cap. Under the facts of this example, each single family residential property would generate a $1,500 credit, for a total of $75,000 (50 properties times $1,500). Commercial: Each commercial property would be treated independently. In each case, twenty percent of $10,000, or $2,000, would be compared against the $500,000 commercial property cap. Under the facts of this example, each commercial property would generate a $2,000 credit, for a total of $20,000 (10 properties times $2,000). The total credit for the $600,000 wind-powered system is $1,500 for each single-family residential property ($75,000) plus $2,000 for each commercial property ($20,000) for a total credit of $95,000.

Example 2: Taxpayer, an independent energy provider installs and places into service a wind farm that does not service any particular property, but is entirely directed into the energy grid of the local electricity provider. The renewable energy technology system will be considered to be servicing commercial property only; no allocation is necessary. However, if an identifiable connection exists to customers situated on the property where the power is produced in addition to a connection to the energy grid of the local electricity provider, then the cost of the system must be allocated among and between the particular property or properties being serviced and the connection to the energy grid, which is treated as servicing a single commercial property.

Example 3: Taxpayer installs and places into service solar energy equipment for a condominium that contains both residential and commercial units. Each condominium unit has a separate title, so each unit would be treated as a separate property. The taxpayer must reasonably allocate the actual cost of the system between the residential and commercial properties. The condominium contains 50 single-family units and 10 commercial units of equal size and use, and a $600,000 photovoltaic energy system that has a total output capacity of 60 kilowatts. The credit is calculated as follows: Allocation of cost: The actual cost per kilowatt is $10,000 ($600,000 divided by 60 kilowatts). Since there are 60 separate units that have equal energy use, the actual cost of a 1 kilowatt portion of the installation must be allocated to each unit. Thus, actual cost of $600,000 would be divided equally among the 60 properties, allocating $10,000 to each property. Single-family residential: Although each system does not meet the total output capacity requirement, subsection 18-235-12.5-03(b)(1) allows a credit to be claimed for each system because only one system has installed and placed into service on each property. Each single-family residential condo unit would be treated independently. In each case, thirty-five percent of $10,000, or $3,500, would be compared against the $5,000 single family residential property cap. Under the facts of this example, each single-family residential property would generate a $3,500 credit, for a total of $175,000 (50 units times $3,500). Commercial: Each commercial condo unit would be treated independently. In each case, thirty-five percent of $10,000, or $3,500, would be compared against the $500,000 commercial property cap. Each commercial property would generate a $3,500 credit, for a total of $35,000 (10 properties times $3,500). The total credit for the $600,000 photovoltaic energy system is $3,500 for each single-family condo unit ($175,000) plus $3,500 for each commercial condo unit ($35,000) for a total credit of $210,000.

(2) For a system installed and placed in service to service a mixed-use property, the actual cost of the system is allocated between the residential use (which may be single-family use or multiple family use) and the commercial use. For a photovoltaic energy system, thirty-five percent of the cost allocated to residential use is compared against either the single-family residential cap or the multiple-family residential cap; and thirty-five percent of the cost allocated to commercial use is compared against the commercial property cap.

Example 4: Taxpayer is a farmer and has a dwelling and barn on one of the lots which is considered to be a mixed-use property. Taxpayer installs and places into service a renewable energy technology system that only services the barn. Allocation by use results in the system being subject only to the commercial property limitations. (Note: This is not an example of the directed use exception; an allocation would still be made, but it would be a 0% residential/100% commercial allocation based upon use.)

Example 5: Same facts as Example 4, but the system services both the barn and the dwelling. A portion of the system's actual cost would be subject to the commercial property limitations and the rest would be subject to the single family residential property limitations.

Example 6: Taxpayer installs and places into service renewable energy technology equipment for an apartment complex that contains both residential and commercial units. Each unit is not separately titled, so each unit would not be treated as separate property. Instead, the titled property is the entire apartment complex. Since the titled property is

mixed-use, the taxpayer will have to reasonably allocate the actual cost of the system between the residential and commercial uses of the property. The complex contains 50 single-family units and 10 commercial units of equal size and use, and a $600,000 photovoltaic energy system that has a total output capacity of 60 kilowatts. The credit would be calculated as follows: Allocation of cost: The actual cost per kilowatt is $10,000 ($600,000 divided by 60 kilowatts). Since each of the units has an equal energy use, the actual cost of $600,000 would be divided between residential use of the property and the commercial use of the property, allocating $500,000 ($10,000 times 50 units) to the residential use and $100,000 ($10,000 times 10 units) to the commercial use. Residential Use: Since the property contains more than one residence, the proper characterization of this use is multi-family residential. Because the installation serves 50 residential units, the total output capacity of each system must be at least 18 kilowatts (0.360 kilowatts times 50 units). The total output capacity of the residential portion of the installation is 50 kilowatts. For the purpose of calculating the credit, two systems that meet the total output capacity requirement and one system that fails to meet the requirement have been installed and placed into service. The actual cost for each of the two systems which meet the 18 kilowatt total output capacity requirement is $180,000 ($10,000 times 18 kilowatts) each. Thirty-five percent of $180,000, or $63,000, would be compared against the multi-family residential property cap, or $17,500 ($350 times 50 units). Because the credit is capped at $17,500 per system, the total credit for the two systems that meet the total output capacity requirement is $35,000 ($17,500 plus $17,500). The third system has an actual cost of $140,000 ($10,000 times 14 kilowatts). Although the system does not meet the total output capacity requirement the credit may be claimed under subsection 18-235-12.5-03(b)(2). Thirty-five percent of $140,000, or $49,000, would be compared against the multi-family residential property cap, or $17,500 ($350 times 50 units). The credit for the third system is $17,500 due to the cap. The total credit for the three systems serving the multi-family residential portion of the property is $52,500 ($17,500 times 3 systems). Commercial Use: Each system serving commercial property must have a total output capacity of at least 1,000 kilowatts. The total output capacity of the installation serving the commercial portion of the property is 10 kilowatts and the actual cost is $100,000 ($10,000 times 10 kilowatts). Since the portion of the installation serving commercial property fails to meet the total output capacity requirement and the credit is already claimed for a system that does not meet the applicable total output capacity requirement on a single property, a credit may not be claimed for the installation that serves the commercial portion of the property. The total credit for the entire $600,000 solar energy installation is $52,500. Note: A credit for the commercial part of the installation may have been claimed if the credit for the third multi-family residential system had not been claimed. [Eff 1/02/14] (Auth: HRS §§231-3(9), 235-12.5, 235-118) (Imp: HRS §235-12.5)

HRS §235-12.5 **§18-235-12.5-06 Application of sections 18-235-12.5-01 through 18-235-12.5-05.** Sections 18-235-12.5-01 through 18-235-12.5-05 shall apply to renewable energy technology systems that are installed and placed in service on or after January 1, 2013. To the extent that sections 18-235-12.5-01 through 18-235-12.5-05 conflict with guidance issued by the department prior to January 1, 2013, these sections shall prevail. [Eff 1/02/14] (Auth: HRS §§231-3(9), 235-12.5, 235-118) (Imp: HRS §235-12.5)

§18-235-13 (Reserved)

HRS §235-20.5 **§18-235-20.5-01 Fees for issuing comfort letters, certificates under section 235-110.9, HRS, and certificates under section 235-110.91, HRS.** (a) The department may charge a fee of $1,000 to any person requesting the issuance of a comfort ruling from the department.

(b) The department may charge the following fees to each person requesting a certificate under section 235-110.9, HRS:

(1) $100 for complete requests received by the department prior to the third Wednesday in January following the year in which the investment was made;

(2) $150 for complete requests received by the department on or after the third Wednesday in January following the year in which the investment was made; or

(3) For entities taxable as a partnership for net income tax purposes, such entities may request a certificate on behalf of their partners or members, and the following fees shall apply:

(A) $750 for complete requests received by the department prior to the third Wednesday in January following the year in which the investment was made; or

(B) $1,000 for complete requests received by the department on or after the third Wednesday in January following the year in which the investment was made.

These fees shall apply provided that the person submits the application for certification in the manner prescribed by the department through published guidance.

(c) The department shall charge the following fees to each person requesting a certificate under section 235-110.91, HRS:

(1) $400 for complete requests received by the department prior to the third Wednesday in January following the year in which the expenses were incurred; or

(2) $750 for complete requests received by the department on or after the third Wednesday in January following the year in which the expenses were incurred.

(d) The department shall require payment in full of any outstanding fees prior to processing a request described in subsection (a), (b), or (c).

(e) No fee shall be required from any person requesting a certificate under sections 235-110.9, HRS, or 235-110.91, HRS, where the credit sought to be claimed is less than $25,000 for the qualified high technology business' taxable year.

(f) As used in this section:

"Comfort ruling" means a ruling concerning the application of the following high technology tax incentives:

(1) The high technology business investment tax credit under section 235-110.9, HRS;

(2) The income tax exclusion for royalties and other income derived from patents and copyrights received by an individual or a qualified high technology business and developed and arising out of a qualified high technology business under section 235-7.3, HRS;

(3) The income tax exclusion for stock options, dividends from stock, the receipt of the options, the exercise of the options, and income from the sale of the options under section 235-9.5, HRS; or

(4) The tax credit for research activities under section 235-110.91, HRS.

"Complete request" means the taxpayer has:

(1) Answered all of the questions listed on the application for certification; and

(2) Executed the application for certification under penalty of perjury. [Eff 11/03/2005] (Auth: HRS §§231-3(9), 235-10, 235-20.5) (Imp: HRS §235-20.5)

SUBCHAPTER 2

DIVISION OF INCOME FOR TAX PURPOSES

§18-235-21-01 (Reserved)

HRS §235-21 **§18-235-21-02 Two or more businesses of a single taxpayer.** (a) A taxpayer may have more than one trade or business. In such cases, it is necessary to determine the business income attributable to each separate trade or business. The income of each business then is apportioned by an apportionment formula which takes into consideration the instate and outstate factors which relate to the trade or business the income of which is being apportioned.

Example: The taxpayer is a conglomerate with three operating divisions. One division is engaged in manufacturing aerospace items for the federal government. Another division is engaged in growing coffee products. The third division produces and distributes motion pictures for theaters and television. Each division operates independently; there is no strong central management. Each division operates in this State as well as in other states. In this case, it is fair to conclude that the taxpayer is engaged in three separate trades or businesses. Accordingly, the amount of business income attributable to the taxpayer's trade or business activities in this State is determined by applying an appropriate apportionment formula to the business income of each separate trade or business.

(b) The determination of whether the activities of the taxpayer constitute a single trade or business or more than one trade or business will turn on the facts in each case. In general, the activities of the taxpayer will be considered a single business if there is evidence to indicate that the segments under consideration are integrated with, dependent upon, or contribute to each other. The following factors are considered to be good indicia of a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the taxpayer constitute a single trade or business:

(1) A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer which only operates a chain of retail grocery stores will almost always be engaged in a single trade or business.

(2) A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.

(3) A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-21)

HRS §235-21 **§18-235-21-03 Business and nonbusiness income application of definitions.** (a) The following are rules and examples for determining whether particular income is business or nonbusiness income. (The examples used throughout these rules are illustrative only and do not purport to set forth all pertinent facts.)

(b) Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or incidental to it and therefore is includable in the property factor under sections 18-235-30-01 to 18-235-30-04.

Example 1: The taxpayer operates a multistate car rental business. The income from car rentals is business income.

Example 2: The taxpayer is engaged in the heavy construction business in which it uses equipment such as cranes, tractors, and earth-moving vehicles. The taxpayer makes short-term leases of the equipment when particular pieces of equipment are not needed on any particular project. The rental income is business income.

Example 3: The taxpayer operates a multistate chain of clothing stores. The taxpayer purchases a five-story office building for use in connection with its trade or business. It uses the street floor as one of its retail stores and the second and third floors for its general corporate headquarters. The taxpayer manages and leases the remaining two floors to others. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. The rental income is business income.

Example 4: The taxpayer operates a multistate chain of grocery stores. It purchases as an investment an office building in another state with surplus funds and hires an unrelated property management company to manage and lease the entire building to others. The net rental income is not business income of the grocery store trade or business. Therefore, the net rental income is nonbusiness income.

Example 5: The taxpayer operates a multistate chain of clothing stores. The taxpayer invests in a twenty-story office building and uses the street floor as one of its retail stores and the second floor for its general corporate headquarters. The taxpayer hires an unrelated property management company to manage and lease the remaining eighteen floors to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. The net rental income is not business income of the clothing store trade or business. Therefore, the net rental income is nonbusiness income.

Example 6: The taxpayer constructed a plant for use in its multistate manufacturing business and twenty years later the plant was closed and put up for sale. The plant was rented for a temporary period from the time it was closed by the taxpayer until it was sold eighteen months later. The rental income is business income and the gain on the sale of the plant is business income.

Example 7: The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The taxpayer hired an unrelated property management company to manage and lease the old building. The property management company leased the building to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The net rental income received over the lease period is nonbusiness income and the gain (or loss) on the sale of the building is nonbusiness income.

(c) Gain or loss from the sale, exchange, or other disposition of real property or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in, available for, or capable of being used in the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, exchange, or other disposition, the gain or loss will constitute nonbusiness income. See sections 18-235-30-01 to 18-235-30-04.

Example 1: In conducting its multistate manufacturing business, the taxpayer systematically replaces automobiles, machines, and other equipment used in the business. The gains or losses resulting from those sales constitute business income.

Example 2: The taxpayer constructed a plant for use in its multistate manufacturing business and twenty years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income.

Example 3: Same as Example 2 except that the plant was closed and put up for sale but was not in fact sold until a buyer was found 18 months later. The gain is business income.

Example 4: Same as Example 2 except that the plant was rented while being held for sale. The rental income is business income and the gain on the sale of the plant is business income.

Example 5: The taxpayer operates a multistate chain of grocery stores. It owned an office building which it occupied as its corporate headquarters. Because of inadequate space, taxpayer acquired a new and larger building elsewhere for its corporate headquarters. The taxpayer hired an unrelated property management company to manage and lease the old building. The property management company leased the building to an unrelated investment company under a five-year lease. Upon expiration of the lease, taxpayer sold the building at a gain (or loss). The gain (or loss) on the sale is nonbusiness income and the rental income received over the lease period is nonbusiness income.

(d) Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations, or where the purpose for acquiring and holding the intangible is related to or incidental to those trade or business operations.

Example 1: The taxpayer operates a multistate chain of department stores, selling for cash and on credit. Service charges, interest, or time-price differentials and the like are received with respect to installment sales and revolving charge accounts. These amounts are business income.

Example 2: The taxpayer conducts a multistate manufacturing business. During the year the taxpayer receives a federal income tax refund and collects a judgment against a debtor of the business. Both the tax refund and the judgment bear interest. The interest income is business income.

Example 3: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as worker's compensation claims, rain and storm damage, and machinery replacement. The moneys in those accounts are invested at interest. Similarly, the taxpayer temporarily invests funds intended for payment of federal, state, and local tax obligations. The interest income is business income.

Example 4: The taxpayer is engaged in a multistate money order and traveler's check business. In addition to the fees received in connection with the sale of the money orders and traveler's checks, the taxpayer earns interest income by the investment of the funds pending their redemption. The interest income is business income.

Example 5: The taxpayer is engaged in a multistate manufacturing and selling business. The taxpayer usually has working capital and extra cash totaling $200,000 which it regularly invests in short-term interest bearing securities. The interest income is business income.

(e) Dividends are business income where the stock with respect to which the dividends are received arises out of or was acquired in the regular course of the taxpayer's trade or business operations or where the purpose of acquiring and holding the stock is related to or incidental to those trade or business operations.

Example 1: The taxpayer operates a multistate chain of stock brokerage houses. During the year, the taxpayer receives dividends on stock that it owns. The dividends are business income.

Example 2: The taxpayer is engaged in a multistate manufacturing and wholesaling business. In connection with that business, the taxpayer maintains special accounts to cover such items as worker's compensation claims. A portion of the moneys in those accounts is invested in interest-bearing bonds. The remainder is invested in various common stocks listed on national stock exchanges. Both the interest income and any dividends are business income.

Example 3: The taxpayer and several unrelated corporations own all of the stock of a corporation whose business operations consist solely of acquiring and processing materials for delivery to the corporate owners. The taxpayer acquired the stock in order to obtain a source of supply of materials used in its manufacturing business. The dividends are business income.

Example 4: The taxpayer is engaged in a multistate heavy construction business. Much of its construction work is performed for agencies of the federal government and various state governments. Under state and federal laws applicable to contracts for these agencies, a contractor must have adequate bonding capacity, as measured by the ratio of its current assets (cash and

marketable securities) to current liabilities. In order to maintain an adequate bonding capacity the taxpayer holds various stocks and interest-bearing securities. Both the interest income and any dividends received are business income.

Example 5: The taxpayer receives dividends from the stock of its subsidiary or affiliate which acts as the marketing agency for products manufactured by the taxpayer. The dividends are business income.

(f) Patent and copyright royalties are business income where the patent or copyright with respect to which the royalties were received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the patent or copyright is related to or incidental to those trade or business operations.

Example 1: The taxpayer is engaged in the multistate business of manufacturing and selling industrial chemicals. In connection with that business, the taxpayer obtained patents on certain of its products. The taxpayer licensed the production of the chemicals in foreign countries, in return for which the taxpayer receives royalties. The royalties received by the taxpayer are business income.

Example 2: The taxpayer is engaged in the music publishing business and holds copyrights on numerous songs. The taxpayer acquires the assets of a smaller publishing company, including music copyrights. These acquired copyrights are thereafter used by the taxpayer in its business. Any royalties received on these copyrights are business income. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-21)

HRS §235-21 **§18-235-21-04 Proration of deductions.** (a) In most cases an allowable deduction of a taxpayer will be applicable only to the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases an allowable deduction may be applicable to the business incomes of more than one trade or business, or to several items of nonbusiness income, or both. In such cases the deduction shall be prorated among the trades or businesses and the items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

(b) In filing returns with this State, if the taxpayer departs from or modifies the manner of prorating any deduction used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(c) If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the application or proration of any deduction, the taxpayer shall disclose in its return to this State the nature and extent of the variance. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-21, 235-5(c), 235-117)

HRS §235-22 **§18-235-22-01 Definitions.** As used in this subchapter:

"Allocation" refers to the assignment of nonbusiness income to a particular state.

"Apportionment" refers to the division of business income between states by the use of a formula containing apportionment factors.

"Combined reporting method" means the same as in section 18-235-22-03.

"Director" means the director of taxation.

"Multistate Tax Compact" means the Multistate Tax Compact as enacted by several of the states of the United States and the District of Columbia, and by this State in section 255-1, HRS.

"Taxpayer" means a taxpayer as defined as in section 235-1, HRS, which:

(1) Has income from business activity that is taxable both in this State and in another State, other than activity as a public utility or the rendering of purely personal services by an individual; or

(2) Conducts business activity within this State and is a member of a unitary group that has income from business activity described in paragraph (1).

"Uniform Division of Income for Tax Purposes Act" means the Uniform Division of Income for Tax Purposes Act as enacted by several of the states of the United States, and by this State in part II of chapter 235, HRS.

"Unitary business" means a business carried on by a group of entities that includes the taxpayer where there are flows of value among the entities resulting from (1) functional integration, (2) centralization of management, or (3) economies of scale. Generally, if the operation of a business within Hawaii is integrated with, is dependent on, or contributes to the operation of the business outside Hawaii, the entire business is unitary in character.

"Unitary group" means a group of entities carrying on a unitary business, but with respect to any taxpayer a unitary group does not include:

(1) Any foreign affiliate (as defined in section 18-235-38.5-02) of the taxpayer; or

(2) Any entity that is not related to the taxpayer within the meaning of section 267(b) and (c) (with respect to disallowance of deductions for transactions between related taxpayers), IRC. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-22)

HRS §235-22 **§18-235-22-02 Apportionment.** If the business activity in respect to any trade or business of a taxpayer occurs both within and without this State, and if by reason of the business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from the trade or business which is attributable to the taxpayer's activity in this State shall be determined by apportionment in accordance with sections 235-28 to 235-36, HRS. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-22)

HRS §235-22 **§18-235-22-03 Combined reporting method; combined return.** (a) As used in this section:

"Combined business income" means the business income of all members of a unitary group from the unitary business.

"Combined reporting method" means the accounting method of determining the portion of the business income of a unitary group that is attributable to the taxpayer's activity in this State with respect to that unitary business.

"Combined return" means a single return that is filed to reflect the income of all taxpayers in a unitary group, but does not mean a consolidated return.

"Designated member" means the member of a group that is designated, pursuant to subsection (d)(3)(B), to represent the group for tax matters relating to a combined return.

"Group" means a unitary group as defined in section 18-235-22-01.

(b) In the combined reporting method, nonbusiness income shall be allocated for each entity separately under sections 235-24 to 235-28, HRS, the same as if there were no group; and the combined business income of the group is apportioned with reference to the income from, and the property, payroll, and sales factors of, the entire unitary business just as would be done if the business had been conducted by one entity rather than a group. This method is different from a consolidated return, which is a taxing method in which two or more corporations are treated as one taxpayer. (See section 18-235-92(d).) In apportioning combined business income:

(1) Transactions between members of the group relating to the unitary business, such as intercompany dividends, royalties, interest payments, sales, and rentals, shall be eliminated in computing combined business income and the property, payroll, and sales factors of each taxpayer in the group.

(2) For each taxpayer in a group, the numerators of the property, payroll, and sales factors shall be those of the taxpayer, and the denominators of the factors shall be those of the group.

(3) The business income attributable to the unitary business of each taxpayer in a group shall be the combined business income multiplied by the average of the taxpayer's property, payroll, and sales factors.

(4) The tax, deductions, credits, and allowances of each member of the group shall be computed separately. Credits, loss carrybacks, or loss carryovers of a group member shall not be applied against the income or Hawaii tax liability of any other group member because of the combined reporting method.

(c) Each taxpayer in a group shall use the combined reporting method to determine its income unless the department permits it to do otherwise under section 235-38, HRS. For purposes of this section, a group of domestic corporations electing to file a consolidated return under section 235-92(2), HRS, shall be treated as one taxpayer.

(d) Each taxpayer in a group shall file a separate return reporting its share of the combined business income or loss of the unitary business, and shall compute its tax, credits, deductions, and allowances separately, except as provided in this subsection.

(1) The department shall permit a combined return to be filed for all of the taxpayers in a group, except when:

(A) Not all of the taxpayers in the group are using the same apportionment formula;

(B) Not all of the taxpayers in the group have the same taxable year; or

(C) The department determines that such a return would prejudice the interests of the State.

(2) If a group includes a taxpayer that is also a member of another unitary group (one with a separate line of business), the department may allow a combined return to be filed for all of the taxpayers in both groups.

(3) An application to file a combined return shall contain:

(A) The names, federal employer identification numbers, and Hawaii general excise tax identification numbers (if applicable) of all group members;

(B) A statement appointing one member as the designated member, and granting power of attorney to the designated member to represent the group for all tax matters related to the combined return;

(C) The agreement of all group members to be jointly and severally liable for all taxes, penalties, interest, and additions to tax of the group; and

(D) The agreement of all group members that a combined return shall be filed for all group members for any year in which any group member had gross income subject to taxation under chapter 235, HRS; and that the designated member, for itself and as agent for all group members, consents to the jurisdiction of the courts of this State solely for purposes of enforcing any summons or subpoena under section 231-7 or 235-108, HRS, for records, testimony, or other evidence pertinent to any combined return of the group.

(4) Once permission to file a combined return is granted, the group shall continue to file a combined return until the department grants written permission to discontinue filing combined returns. An application to discontinue filing combined returns shall be submitted by the designated member at least ninety days prior to the filing due date of the combined return, including extensions of time. The application shall state the reasons for discontinuing filing combined returns.

(5) An application to change which members of the group are included in a group's combined return shall contain the items set forth in paragraph (3) with respect to the group after the proposed change.

(6) If a group files a combined return, the group also shall file and pay estimated tax on a combined basis until permission to discontinue filing combined returns is received from the department.

(7) Use of a combined return shall not affect the applicability of other provisions of chapter 235, HRS, to the taxpayers separately. For example, unless otherwise authorized by law or these rules, each taxpayer in a group is separately liable for filing withholding tax returns and payments. Furthermore, the tax liability of each taxpayer in a group shall be computed separately, unless otherwise authorized by law or these rules.

(e) If a taxpayer is using the combined reporting method and the taxable year of any group member is not identical with that of the taxpayer:

(1) In using the combined reporting method, the taxpayer shall convert the income, property, payroll, and sales factors of the group member to correspond to the taxpayer's taxable year. Where this procedure results in using the business income and apportionment factors of an entity whose income year has not yet closed, the taxpayer shall make an estimate based on available information and amend the return not later than the date on which the group member's return is due (including extensions).

Example: Corporation T operates on a calendar year basis and conducts a unitary business with Corporation U, which operates with a September 30 year end. T is employing the combined reporting method (but is not filing a combined return) with U. T, in computing combined business income for 1993, shall include 9/12 of U's income for the year ending September 30, 1993, and 3/12 of U's estimated income for the year ending September 30, 1994. In computing T's property, payroll, and sales factors, a similar computation shall be performed on U's property, payroll, and sales factor denominators. If no extensions are given, T shall file its return on April 20, 1994, and shall amend its return no later than January 20, 1995, the same time U's return is due for the year ending September 30, 1994, with a revised apportionment computation using U's actual income and U's actual property, payroll, and sales factor denominators.

(2) Alternatively, and provided that the combined business income or apportionment factors are not materially distorted, the taxpayer may elect to include the income, property, payroll, and sales for the group member's taxable year that ends within the taxable year of the taxpayer.

(f) Where a taxpayer is authorized to use an apportionment formula other than that set forth in section 235-29, HRS, references in this section to the property, payroll, and sales factors instead shall refer to the factors in the apportionment formula that are being used by the taxpayer; and references to property, payroll, and sales shall instead refer to the components of factors in the apportionment formula that are being used by the taxpayer. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-22, 235-92, 235-97)

HRS §235-22 **§18-235-22-04 Allocation.** A taxpayer shall allocate all of its nonbusiness income or loss within or without this State in accordance with sections 235-23 to 235-27, HRS. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-22)

HRS §235-22 **§18-235-22-05 Consistency and uniformity in reporting.** (a) In filing returns with this State, if the taxpayer departs from or modifies the manner in which income has been classified as business income or nonbusiness income in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(b) If the returns or reports filed by a taxpayer for all states to which the taxpayer reports under Article IV of the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the classification of income as business or nonbusiness income, the taxpayer shall disclose in its return to this State the nature and extent of the variance. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-22, 235-117)

HRS §235-23 **§18-235-23-01 Taxable in another state; in general.** (a) Under section 235-22, HRS, the taxpayer is subject to the allocation and apportionment provisions of sections 235-21 to 235-29, HRS, if it has income from business activity that is taxable both within and without this State. A taxpayer's income from business activity is taxable without this State if the taxpayer, by reason of that business activity (i.e., the transactions and activity occurring in the regular course of a particular trade or business), is taxable in another state within the meaning of section 235-23, HRS.

(b) A taxpayer is taxable in another state if it meets either one of two tests:

(1) If by reason of business activity in another state, the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or

(2) If by reason of that business activity, another state has jurisdiction to subject the taxpayer to a net income tax, whether or not the state imposes such a tax on the taxpayer.

(c) A taxpayer is not taxable in another state with respect to a particular trade or business merely because the taxpayer conducts activities in that other state pertaining to the production of nonbusiness income or business activities relating to a separate trade or business. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-23)

HRS §235-23 **§18-235-23-02 When a taxpayer is subject to a tax under section 235-23(1), HRS.** (a) A taxpayer is subject to one of the taxes specified in section 235-23(1), HRS, if it carries on business activity in a state and the state imposes such a tax on that activity. Any taxpayer which asserts that it is subject to one of the taxes specified in section 235-23(1), HRS, in another state shall furnish to the department upon its request evidence to support that assertion. The department may request that such evidence include proof that the taxpayer has filed the requisite tax return in the other state and has paid any taxes imposed under the law of the other state; the taxpayer's failure to produce that proof may be taken into account in determining whether the taxpayer in fact is subject to one of the taxes specified in section 235-23(1), HRS, in the other state. The federal income tax imposed under chapter 1 of the federal Internal Revenue Code is not one of the taxes specified in section 235-23(1), HRS.

(b) If the taxpayer voluntarily files and pays one or more of those taxes when not required to do so by the laws of that state or pays a minimal fee for qualification, organization, or the privilege of doing business in that state, but

(1) Does not actually engage in business activity in that state; or

(2) Does actually engage in some business activity, not sufficient for nexus, and the minimum tax bears no relationship to the taxpayer's business activity in that state,

the taxpayer is not subject to one of the taxes specified in section 235-23(1), HRS.

Example: State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return and pays the $50 minimum tax, although it carries on no business activity in State A. Corporation X is not taxable in State A.

(c) The concept of taxability in another state is based upon the premise that every state in which the taxpayer is engaged in business activity may impose an income tax even though every state does not do so. In states which do not, other types of taxes may be imposed as a substitute for an income tax. Therefore, only those taxes which may be considered as basically revenue raising rather than regulatory measures shall be considered in determining whether the taxpayer is subject to one of the taxes specified in section 235-23(1), HRS, in another state.

Example 1: State A requires all nonresident corporations which qualify or register in State A to pay to the Secretary of State an annual license fee or tax for the privilege of doing business in the state regardless of whether the privilege is in fact exercised. The amount paid is determined according to the total authorized capital stock of the corporation; the rates are progressively higher by bracketed amounts. The statute sets a minimum fee of $50 and a maximum fee of $500. Failure to pay the tax bars a corporation from utilizing the state courts for enforcement of its rights. State A also imposes a corporation income tax. Nonresident Corporation X is qualified in State A and pays the required fee to the Secretary of State but does not carry on any business activity in State A (although it may utilize the courts of State A). Corporation X is not taxable in State A.

Example 2: Same facts as Example 1, except that Corporation X is subject to and pays the corporation income tax. Payment is prima facie evidence that Corporation X is subject to the net income tax of State A and is taxable in State A.

Example 3: State B requires all nonresident corporations qualified or registered in State B to pay to the Secretary of State an annual permit fee or tax for doing business in the state. The base of the fee or tax is the sum of (1) outstanding capital stock, and (2) surplus and undivided profits. The fee or tax base attributable to State B is determined by a three factor apportionment formula. Nonresident Corporation X which operates a plant in State B, pays the required fee or tax to the Secretary of State. Corporation X is taxable in State B.

Example 4: State A has a corporation franchise tax measured by net income for the privilege of doing business in that state. Corporation X files a return based upon its business activity in the state but the amount of computed liability is less than the minimum tax. Corporation X pays the minimum tax. Corporation X is subject to State A's corporation franchise tax. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-23)

HRS §235-23 **§18-235-23-03 When a state has jurisdiction to subject a taxpayer to a net income tax.** (a) The second test, that of section 235-23(2), HRS, applies if the taxpayer's business activity is sufficient to give the state jurisdiction to impose a net income tax by reason of that business activity under the Constitution and statutes of the United States. Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provisions of Public Law 86-272, 15 U.S.C. sections 381-384.

(b) For a state that is a foreign country or a political subdivision of a foreign country, the determination of whether the state has jurisdiction to subject the taxpayer to a net income tax shall be made as though the jurisdictional standards applicable to a state of the United States applied in that state. If jurisdiction is otherwise present, that state is not considered as being without jurisdiction by reason of the provisions of a treaty between that state and the United States.

Example: Corporation X is actively engaged in manufacturing farm equipment in State A and in foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-23)

§18-235-24 to §18-235-28 (Reserved.)

HRS §235-29 **§18-235-29-01 Apportionment formula.** All business income of each trade or business of the taxpayer shall be apportioned to this State by use of the apportionment formula set forth in section 235-29, HRS. The elements of the apportionment formula are the property factor (see sections 18-235-30-01 to 18-235-32-01), the payroll factor (see sections 18-235-33-01 to 18-235-34-01) and the sales factor (see sections 18-235-35-01 to 18-235-37-01) of the trade or business of the taxpayer. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-29)

HRS §235-29 **§18-235-29-02 Apportionment formula; denominator of zero.** If the denominator of the property factor, payroll factor, or sales factor is zero, then the denominator of the fraction in section 235-29, HRS, shall be reduced by the number of factors with a zero denominator, and the numerator of that fraction shall not include any factor with a zero denominator.

Example: X is a company that provides data entry services to United States companies. X performs its services exclusively through employees of F, its foreign parent that does no business

in the United States. X has no employees of its own. X's property factor is 5 per cent, its sales factor is 17 per cent, and its payroll factor has a zero denominator. X's apportionment percentage is 11 per cent (5 per cent plus 17 per cent, divided by 2). [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §235-29)

HRS §235-29 **§18-235-29-03 Apportionment for installment sales.** (a) Income from installment sales shall be apportioned on the basis of the apportionment percentage for the year of sale. This is because installment sale income is reported at least in part in a year other than the year in which the sale took place, and apportionment of installment sale income on the basis of the factors in the years other than the year of sale would result in that income being apportioned by activities that had no connection with the earning of the income.

(b) This rule applies whether or not the income from the sale was included in the sales factor for the year of sale.

Example: X is doing business in states A and B, and this State. In 1988, the taxpayer sold a plant in state A and realized a $500,000 gain on the sale which is properly classified as business income under section 18-235-21-03(c). The taxpayer elects to report on the installment method. Under applicable federal principles (section 453, IRC, as operative under chapter 235, HRS), the gain is recognized in two equal installments in 1989 and 1990. The taxpayer's apportionment percentages are as follows:

Taxable Year	Apportionment Percentage
1988	11%
1989	1%
1990	32%

In 1989, X's apportioned business income includes $250,000 (gain recognized in 1989) x 11 per cent (apportionment factor for year of sale) = $27,500. In 1990, X's apportioned business income includes $250,000 (gain recognized in 1990) x 11 per cent (apportionment factor for year of sale) = $27,500. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §235-29)

HRS §235-29 **§18-235-29-04 Apportionment formula as applied to partnerships.** (a) If a taxpayer is a partner in a partnership, and the partnership's activities and the taxpayer's activities constitute a unitary business:

(1) The taxpayer's share of the partnership's trade or business shall be combined with the taxpayer's trade or business;
(2) The property, payroll, and sales factors, or other applicable factors, of the taxpayer and the partnership shall be combined; and
(3) Intercompany items shall be eliminated, under the principles set forth in section 18-235-22-03.

Example 1: Corporation A's distributive share of income in partnership P is 20 per cent. Corporation A manufactures toys which are sold in the seven western states by partnership P. Corporation A's business income for the year was $1,000,000 and partnership P's business income for the same year was $800,000. The business income of corporation A is $1,160,000 ($1,000,000 plus 20 per cent of $800,000).

Example 2: The facts are the same as in Example 1. Partnership P owns a building with an original cost of $100,000 which is rented to corporation A for $12,000 per year. Corporation A shall include $20,000 (20 per cent of $100,000) in its property factor because of its interest in partnership P. In addition, Corporation A shall take into account $9,600 ($12,000 less 20 per cent of $12,000) of rental expense into its property factor in order to include in the property factor the rented building used in Corporation A's operation. Thus, Corporation A shall include $76,800 ($9,600 multiplied by 8, pursuant to section 235-31, HRS) for the rent paid, and $20,000 for its interest in the building through Partnership P, in its property factor, totalling $96,800 attributable to the building.

(b) If a taxpayer is a partner in a partnership, and the partnership's activities and the taxpayer's activities do not constitute a unitary business, the partnership shall allocate and apportion its income at the partnership level. The taxpayer's distributive share of the partnership's income allocated or apportioned to this State shall not be subject to further apportionment by the taxpayer.

Example: Corporation A's distributive share of income in partnership P is 20 per cent. Corporation A manufactures and sells toys in the seven western states. Partnership P operates farms within and without this State. Both corporation A and partnership P earn exclusively business income, except for distributions from Partnership P. Corporation A's business income for the year is $1,000,000 and partnership P's income is $800,000 for the same year. Because corporation A and partnership P are engaged in two different trades or businesses, corporation A shall apportion its $1,000,000 income on the basis of its own apportionment formula. Partnership P shall apportion its business income of $800,000 on the basis of its own apportionment formula. Corporation A's apportionment factors are determined without regard to Partnership P's apportionment factors, and vice versa. Assume that corporation A's apportionment percentage determined under section 18-235-29-01 is 35 per cent, and that partnership P's apportionment percentage is 10 per cent. Partnership P's Hawaii income is 10 per cent of the income from its farming business ($80,000 = 10 per cent x $800,000). Corporation A is taxable in this State upon 35 per cent of the income from its toy manufacturing business ($350,000 = 35 per cent x $1,000,000) plus its full distributive share of the partnership income attributed to this State ($16,000 = 20 per cent x $80,000), or $366,000. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §235-29)

HRS §235-30 **§18-235-30-01 Property factor; in general.** (a) The property factor of the apportionment formula for each trade or business of the taxpayer shall include all real and tangible personal property owned or rented by the taxpayer and used during the tax period in the regular course of the trade or business.

(b) "Real and tangible personal property" includes land, buildings, machinery, stocks of goods, equipment, and other real and tangible personal property but does not include money.

(c) Property used in connection with the production of nonbusiness income shall be excluded from the property factor. Property used both in the regular course of the taxpayer's trade or business and in the production of nonbusiness income shall be included in the factor only to the extent that the property is used in the regular course of the taxpayer's trade or business.

(d) The method of determining that portion of the value to be included in the factor will depend upon the facts of each case. The property factor shall include the average value of property includable in the factor. See section 18-235-32-01. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-30)

HRS §235-30 **§18-235-30-02 Property factor; property used for the production of business income.** (a) Property shall be included in the property factor if it is actually used or is available for or capable of being used during the tax period in the regular course of the trade or business of the taxpayer.

(b) Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor.

(c) Property or equipment under construction during the tax period (except inventoriable goods in process) shall be excluded from the factor until that property is actually used in the regular course of the trade or business of the taxpayer. If the property is partially used in the regular course of the trade or business of the taxpayer while under construction, the value of the property to the extent used shall be included in the property factor.

(d) Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time during which the property is held for sale. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-30)

HRS §235-30 **§18-235-30-03 Property factor; consistency in reporting.** (a) In filing returns with this State, if the taxpayer departs from or modifies the manner of valuing property, or of excluding or including property in the property factor, used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(b) If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the valuation of property and in the exclusion or inclusion of property in the property factor, the taxpayer shall disclose in its return to this State the nature and extent of the variance. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-30, 235-117)

HRS §235-30 **§18-235-30-04 Property factor; numerator.** (a) The numerator of the property factor shall include the average value of the real and tangible personal property owned, rented, or leased by the taxpayer and used in this State during the tax period in the regular course of the trade or business of the taxpayer.

(b) Property in transit between locations of the taxpayer to which it belongs shall be considered to be at the destination for purposes of the property factor. Property in transit between a buyer and seller which is included by a taxpayer in the denominator of its property factor in accordance with its regular accounting practices shall be included in the numerator according to the state of destination.

(c) The value of mobile or movable property such as construction equipment, trucks, or leased electronic equipment which are located within and without this State during the tax period shall be determined for purposes of the numerator of the factor on the basis of total time within the State during the tax period.

(d) A motor vehicle assigned to a traveling employee shall be included in the numerator of the factor of the state to which the employee's compensation is assigned under the payroll factor or in the numerator of the state in which the motor vehicle is licensed. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-30)

HRS §235-30 **§18-235-30-05 Special rules; property factor.** For special rules concerning the application of the property factor, see section 18-235-38-02. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §§235-31, 235-38)

HRS §235-31 **§18-235-31-01 Property factor; valuation of owned property.** (a) Property owned by the taxpayer shall be valued at its original cost. As a general rule, original cost is deemed to be the basis of the property for federal income tax purposes (before any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements and partial dispositions. However, capitalized intangible drilling and development costs shall be included in the property factor whether or not they have been expensed for either federal or state tax purposes.

Example 1: The taxpayer acquired a factory building in this State at a cost of $500,000 and, eighteen months later, expended $100,000 for major remodeling of the building. Taxpayer files its return for the current taxable year on the calendar-year basis. A depreciation deduction in the amount of $22,000 was claimed with respect to the building on the return for the current taxable year. The value of the building includable in the numerator and denominator of the property factor is $600,000; the depreciation deduction is not taken into account in determining the value of the building for purposes of the factor.

Example 2: During the current taxable year, Corporation X merges into Corporation Y in a tax-free reorganization under the Internal Revenue Code. At the time of the merger, Corporation X owns a factory which X built five years earlier at a cost of $1,000,000. X has been depreciating the factory at the rate of two per cent per year, and its basis in X's hands at the time of the merger is $900,000. Since the property is acquired by Y in a transaction in which, under the Internal Revenue Code, its basis in Y's hands is the same as its basis in X's hands, Y includes the property in Y's property factor at X's original cost, without adjustment for depreciation, i.e., $1,000,000.

Example 3: Corporation Y acquires the stock of Corporation X and makes an election under section 338 of the Internal Revenue Code of 1986 (with respect to certain stock purchases treated as asset acquisitions). Under these circumstances, Y's cost of the assets is the purchase price of the X stock, prorated over the X assets.

If the original cost of property is unascertainable, the property is included in the factor at its fair market value as of the date of acquisition by the taxpayer.

(b) Inventory of stock of goods shall be included in the factor in accordance with the valuation method used for federal income tax purposes.

(c) Property acquired by gift or inheritance shall be included in the factor at its basis for determining depreciation for federal income tax purposes. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-31)

HRS §235-31 **§18-235-31-02 Property factor; valuation of rented property.** (a) Property rented or leased by the taxpayer is valued at eight times its net annual rental rate.

(1) The net annual rental rate for any item of rented property is the annual rental rate paid by the taxpayer for the property less the aggregate annual subrental rates paid by subtenants of the taxpayer. (See section 18-235-38-02 for special rules when the use of such net annual rental rate produces a negative or clearly inaccurate value or when property is used by the taxpayer at no charge or is rented at a nominal rental rate.)

(2) Subrents are not deducted when the subrents constitute business income because the property which produces the subrents is used in the regular course of a trade or business

of the taxpayer when it is producing that income. Accordingly, there is no reduction in its value.

Example 1: The taxpayer receives subrents from a bakery concession in a food market operated by the taxpayer. Since the subrents are business income, they are not deducted from rent paid by the taxpayer for the food market.

Example 2: The taxpayer rents a five-story office building primarily for use in its multistate business, uses three floors for its offices, and manages and subleases two floors to various other businesses and persons such as professional people and shops. The rental of the two floors is incidental to the operation of the taxpayer's trade or business. Since the subrents are business income, they are not deducted from the rent paid by the taxpayer.

Example 3: The taxpayer rents a twenty-story office building and uses the lower two stories for its general corporation headquarters. The taxpayer hires an unrelated property management company to manage and sublease the remaining eighteen floors to others. The rental of the eighteen floors is not incidental to but rather is separate from the operation of the taxpayer's trade or business. Since the subrents are nonbusiness income they shall be deducted from the rent paid by the taxpayer.

(b) As used in this section:

"Annual rental rate" means the amount paid as rental for property for a twelve-month period (i.e., the amount of the annual rent).

(1) Where property is rented for less than a twelve-month period, the rent paid for the actual period of rental shall constitute the annual rental rate for the tax period.

(2) Where a taxpayer has rented property for a term of twelve or more months and the current tax period covers a period of less than twelve months (due, for example, to a reorganization or change of accounting period), the rent paid for the short tax period shall be annualized.

(3) If the rental term is for less than twelve months, the rent shall not be annualized beyond its term.

(4) Rent shall not be annualized because of the uncertain duration when the rental term is on a month-to-month basis.

Example 1: Taxpayer A, which ordinarily files its returns based on a calendar year, is merged into Taxpayer B on April 30. The net rent paid under a lease with five years remaining is $2,500 a month. The rent for the tax period January 1 to April 30 is $10,000. After the rent is annualized the net rent is $30,000 ($2,500 x 12).

Example 2: Same facts as in Example 1 except that the lease would have terminated on August 31. In this case, the annualized rent is $20,000 ($2,500 x 8).

"Rent" means the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property.

(1) Rent includes any amount payable for the use of real or tangible personal property, or any part of it, whether designated as a fixed sum of money or as a percentage of sales, profits, or otherwise.

Example: A taxpayer, pursuant to the terms of a lease, pays a lessor $1,000 per month as a base rental and at the end of the year pays the lessor one per cent of its gross sales of $400,000. The annual rent is $16,000 ($12,000 plus one per cent of $400,000 or $4,000).

(2) Rent includes any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance on the demised premises, repairs, or any other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities or janitor services. If a payment includes rent and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and other items.

Example 1: A taxpayer, pursuant to the terms of a lease, pays the lessor $12,000 a year rent plus taxes in the amount of $2,000 and interest on a mortgage in the amount of $1,000. The annual rent is $15,000.

Example 2: A taxpayer stores part of its inventory in a public warehouse. The total charge for the year was $1,000 of which $700 was for the use of storage space and $300 for inventory insurance, handling and shipping charges, and C.O.D. collections. The annual rent is $700.

(3) Rent does not include incidental day-to-day expenses such as hotel or motel accommodations, or daily rental of motor vehicles.

(4) Rent does not include royalties based on extraction of natural resources, whether represented by delivery or purchase. For this purpose, a royalty includes any consideration conveyed or credited to a holder of an interest in property which constitutes a sharing of current or future production of natural resources from such property, irrespective of the method of payment or how such consideration may be characterized, whether as a royalty, advance royalty, rental, or otherwise.

(c) Leasehold improvements, for purposes of the property factor, shall be treated as property owned by the taxpayer regardless of whether the taxpayer is entitled to remove the improvements or the improvements revert to the lessor upon expiration of the lease. Hence, the original cost of leasehold improvements shall be included in the factor.

(d) If a payment is made by a taxpayer to acquire a leasehold interest or a leased fee, rent includes the portion of the payment that is reported by the taxpayer as rental expense. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-31)

HRS §235-31 **§18-235-31-03 Property factor; special rules.** For special rules concerning application of the property factor, see section 18-235-38-02. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §§235-31, 235-38)

HRS §235-32 **§18-235-32-01 Property factor; averaging property values.** (a) As a general rule, the average value of property owned by the taxpayer shall be determined by averaging the values at the beginning and ending of the tax period. However, the department may require or allow averaging by monthly values if that method of averaging is required to properly reflect the average value of the taxpayer's property for the tax period.

(b) Averaging by monthly values will generally be applied if substantial fluctuations in the values of the property exist during the tax period or if property is acquired after the beginning of the tax period or disposed of before the end of the tax period.

Example: The monthly value of the taxpayer's property was as follows:

January	$ 2,000	July	$ 15,000
February	2,000	August	17,000
March	3,000	September	23,000
April	3,500	October	25,000
May	4,500	November	13,000
June	10,000	December	2,000
	$ 25,000		$ 95,000
		Total	$120,000

The average value of the taxpayer's property includable in the property factor for the income year is determined as follows:

$$\frac{\$\ 120{,}000}{12} = \$\ 10{,}000$$

Averaging with respect to rented property is achieved automatically by the method of determining the net annual rental rate of that property as set forth in section 18-235-31-02. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-32)

HRS §235-33 **§18-235-33-01 Payroll factor; in general.** (a) The payroll factor of the apportionment formula for each trade or business of the taxpayer shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period.

(b) The total amount paid to employees is determined with reference to the taxpayer's accounting method. If the taxpayer has adopted the accrual method of accounting, all compensation properly accrued shall be deemed to have been paid. Notwithstanding the taxpayer's method of accounting, at the election of the taxpayer, compensation paid to employees may be included in the payroll factor by use of the cash method if the taxpayer is required to report such compensation under that method for unemployment compensation purposes.

(c) The compensation of any employee on account of activities which are connected with the production of nonbusiness income shall be excluded from the factor.

Example 1: The taxpayer uses some of its employees in the construction of a storage building which, upon completion, is used in the regular course of the taxpayer's trade or business. The wages paid to those employees are treated as a capital expenditure by the taxpayer. The amount of those wages is included in the payroll factor.

Example 2: The taxpayer owns various securities which it holds as an investment separate and apart from its trade or business. The management of the taxpayer's investment portfolio is the only duty of X, an employee. The salary paid to X is excluded from the payroll factor.

(d) As used in sections 235-33 and 235-34, HRS, and the rules interpreting these sections:

"Compensation" means wages, salaries, commissions, and any other form of remuneration paid to employees for personal services. Payments made to an independent contractor or any other person not properly classifiable as an employee are excluded. Only amounts paid directly to employees are included in the payroll factor. Amounts considered paid directly include the value of board, rent, housing, lodging, and other benefits or services furnished to employees by the taxpayer in return for personal services provided that the amounts constitute income to the recipient under the Internal Revenue Code. In the case of employees not subject to the Internal Revenue Code, such as those employed in foreign countries, the determination of whether benefits or services would constitute income to the employees shall be made as though the employees were subject to the Internal Revenue Code.

"Employee" means (1) any officer of a corporation, or (2) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee. Generally, a person will be considered to be an employee if the person is included by the taxpayer as an employee for purposes of the payroll taxes imposed by the Federal Insurance Contributions Act, Internal Revenue Code chapter 21; except that, since certain individuals are employees under the Federal Insurance Contributions Act who would not be employees under the usual common-law rules, it may be established that a person who is included as an employee for purposes of the Federal Insurance Contributions Act is not an employee for purposes of this subchapter.

(e) In filing returns with this State, if the taxpayer departs from or modifies the treatment of compensation paid used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(f) If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the treatment of compensation paid, the taxpayer shall disclose in its return to this State the nature and extent of the variance. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-33, 235-117)

HRS §235-33 **§18-235-33-02 Payroll factor; denominator.** The denominator of the payroll factor is the total compensation paid everywhere during the tax period. Accordingly, compensation paid to employees whose services are performed entirely in a state where the taxpayer is immune from taxation, for example, by Public Law 86-272, is included in the denominator of the payroll factor.

Example: A taxpayer has employees in its state of legal domicile (State A) and is taxable in State B. In addition the taxpayer has other employees whose services are performed entirely in State C where the taxpayer is immune from taxation under Public Law 86-272. As to these latter employees, the compensation will be assigned to State C where their services are performed (i.e., included in the denominator but not the numerator of the payroll factor) even though the taxpayer is not taxable in State C. If the taxpayer is a corporation incorporated in this State, however, under section 235-4(d), HRS, that compensation shall be assigned to this State. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-33)

HRS §235-33 **§18-235-33-03 Payroll factor; numerator.** The numerator of the payroll factor is the total amount paid in this State during the tax period by the taxpayer for compensation. If compensation paid to employees is included in the payroll factor by use of the cash method of accounting or if the taxpayer is required to report compensation under that method for unemployment compensation purposes, it shall be presumed that the total wages reported by the taxpayer to this State for unemployment compensation purposes constitute compensation paid in this State except for compensation excluded under sections 18-235-33-01 to 18-235-34-01. The presumption may be overcome by satisfactory evidence that an employee's compensation is not properly reportable to this State for unemployment compensation purposes. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-33)

HRS §235-34 **§18-235-34-01 Payroll factor; compensation paid in this State.** (a) Compensation is paid in this State if any one of the following tests, applied consecutively, is met:

(1) The employee's service is performed entirely within the State.

(2) The employee's service is performed both within and without the State, but the service performed without the State is incidental to the employee's service within the State. In this paragraph, "incidental" means any service which is temporary or transitory in nature, or which is rendered in connection with an isolated transaction.

(3) If the employee's services are performed both within and without this State, the employee's compensation shall be attributed to this State:

(A) If the employee's base of operations is in this State;

(B) If there is no base of operations in any state in which some part of the service is performed, but the place from which the service is directed or controlled is in this State; or

(C) If the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed but the employee's residence is in this State.

(b) As used in sections 235-33 and 235-34, HRS, and the rules thereunder:

"Base of operations" means the place of more or less permanent nature from which the employee starts work and to which the employee customarily returns in order to receive instructions from the taxpayer or communications from customers or other persons or to replenish stock or other materials, repair equipment, or perform any other functions necessary to the exercise of the employee's trade or profession at some other point or points.

"Place from which the service is directed or controlled" means the place from which the power to direct or control is exercised by the taxpayer. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-34)

HRS §235-35 **§18-235-35-01 Sales factor; in general.** (a) "Sales" means all gross receipts of the taxpayer not allocated under sections 235-24 to 235-28, HRS. Thus, for the purposes of the sales factor of the apportionment formula for each trade or business of the taxpayer, sales means all gross receipts derived by the taxpayer from transactions and activity in the regular course of that trade or business. The following are rules for determining sales in various situations:

(1) In the case of a taxpayer engaged in manufacturing and selling or purchasing and reselling goods or products, sales includes all gross receipts from the sale of goods or products (or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the tax period) held by the taxpayer primarily for sale to customers in the regular course of its trade or business. Gross receipts for this purpose means gross sales less returns and allowances, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to those sales. Federal and state excise taxes (including sales taxes and general excise taxes under chapter 237, HRS) shall be included as part of the seller's receipts if the taxes are passed on to the buyer or included as part of the selling price of the product.

(2) In the case of cost plus fixed fee contracts, such as the operation of a government-owned plant for a fee, sales includes the entire reimbursed cost plus the fee.

(3) In the case of a taxpayer engaged in providing services, sales includes the gross receipts from the performance of those services, including fees, commissions, and similar items.

(4) In the case of a taxpayer engaged in renting real or tangible property, sales includes the gross receipts from the rental, lease, or licensing the use of the property.

(5) In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, sales includes the gross receipts from those activities.

(6) If a taxpayer derives receipts from the sale of equipment used in its business, those receipts constitute sales. For example, a truck express company owns a fleet of trucks and sells its trucks under a regular replacement program. The gross receipts from the sales of the trucks are included in the sales factor. See section 18-235-38-03 for rules that would apply if the sales were occasional.

(b) In some cases certain gross receipts shall be disregarded in determining the sales factor in order that the apportionment formula will operate fairly to apportion to this State the income of the taxpayer's trade or business. See section 18-235-38-03.

(c) In filing returns with this State, if the taxpayer departs from or modifies the basis for excluding or including gross receipts in the sales factor used in returns for prior years, the taxpayer shall disclose in the return for the current year the nature and extent of the modification.

(d) If the returns or reports filed by a taxpayer with all states to which the taxpayer reports under Article IV of the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act are not uniform in the inclusion or exclusion of gross receipts, the taxpayer shall disclose in its return to this State the nature and extent of the variance. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-35, 235-117)

HRS §235-35 **§18-235-35-02 Sales factor; denominator.** The denominator of the sales factor shall include the total gross receipts derived everywhere by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under section 18-235-38-03. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-35)

HRS §235-35 **§18-235-35-03 Sales factor; numerator.** The numerator of the sales factor shall include gross receipts attributable to this State and derived by the taxpayer from transactions and activity in the regular course of its trade or business. All interest income, service charge, carrying charges, or time-price differential charges incidental to those gross receipts shall be included regardless of (1) the place where the accounting records are maintained or (2) the location of the contract or other evidence of indebtedness. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-35)

HRS §235-35 **§18-235-35-04 Sales factor; special rules.** For special rules concerning application of the sales factor, see section 18-235-38-03. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §§235-35 to 235-38)

HRS §235-35 **§18-235-35-05 Sales factor; no effect on warehousing exemption.** Nothing in sections 235-35 to 235-37, HRS, or the rules under those sections shall be construed to expand or limit the exemption in section 235-6, HRS. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §§235-6, 235-35)

HRS §235-36 **§18-235-36-01 Sales factor; sales of tangible personal property in this State.** (a) Gross receipts from sales of tangible personal property (except sales to the United States Government; see section 18-235-36-02) are in this State:

(1) If the property is delivered or shipped to a purchaser within this State regardless of the f.o.b. point or other conditions of sale; or

(2) If the property is shipped from an office, store, warehouse, factory, or other place of storage in this State and the taxpayer is not taxable in the state of the purchaser.

(b) Property shall be deemed to be delivered or shipped to a purchaser within this State if the recipient is located in this State, even though the property is ordered from outside this State.

Example: The taxpayer, with inventory in State A, sold $100,000 of its products to a purchaser having branch stores in several states, including this State. The order for the purchase was placed by the purchaser's central purchasing department located in State B. $25,000 of the purchase order was shipped directly to purchaser's branch store in this State. The branch store in this State is the purchaser within this State with respect to $25,000 of the taxpayer's sales.

(c) Property is delivered or shipped to a purchaser within this State if the shipment terminates in this State, even though the property is subsequently transferred by the purchaser to another state.

Example: The taxpayer makes a sale to a purchaser who maintains a central warehouse in this State at which all merchandise purchases are received. The purchaser reships the goods to its branch stores in other states for sale. All of the taxpayer's products shipped to the purchaser's warehouse in this State constitute property delivered or shipped to a purchaser within this State.

(d) In this section, "purchaser within this State" includes the ultimate recipient of the property if the taxpayer in this State, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this State.

Example: A taxpayer in this State sold merchandise to a purchaser in State A. Taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in this State pursuant to purchaser's instructions. The sale by the taxpayer is in this State.

(e) When property being shipped by a seller from the state of origin to a consignee in another state is diverted to a purchaser in this State while en route, the sales are in this State.

Example: The taxpayer, a produce grower in State A, begins shipment of perishable produce to the purchaser's place of business in State B. While en route, the produce is diverted to the purchaser's place of business in this State in which state the taxpayer is subject to tax. The sale by the taxpayer is attributed to this State.

(f) If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this State if the property is shipped from an office, store, warehouse, factory, or other place of storage in this State.

Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in this State. Taxpayer's only activity in State B is the solicitation of orders by a resident salesperson. All orders by the State B salesperson are sent to the branch office in this State for approval and are filled by shipment from the inventory in this State. Since the taxpayer is immune under Public Law 86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to this State, the state from which the merchandise was shipped.

(g) If a taxpayer whose salesperson operates from an office located in this State makes a sale to a purchaser in another state in which the taxpayer is not taxable and the property is shipped directly by a third party to the purchaser, the following rules apply:

(1) If the taxpayer is taxable in the state from which the third party ships the property, then the sale is in that state.

(2) If the taxpayer is not taxable in the state from which the property is shipped, then the sale is in this State.

Example: The taxpayer in this State sold merchandise to a purchaser in State A. Taxpayer is not taxable in State A. Upon direction of the taxpayer, the merchandise was shipped directly to the purchaser by the manufacturer in State B. If the taxpayer is taxable in State B, the sale is in State B. If the taxpayer is not taxable in State B, the sale is in this State. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-36)

HRS §235-36 **§18-235-36-02 Sales factor; sales of tangible personal property to United States Government in this State.** Gross receipts from sales of tangible personal property to the United States Government are in this State if the property is shipped from an office, store, warehouse, factory, or other place of storage in this State. For the purposes of this section, only sales for which the United States Government makes direct payment to the seller pursuant to the terms of a contract with an agency or instrumentality of the United States constitute sales to the United States Government. Thus, as a general rule, sales by a subcontractor to the prime contractor, the party to the contract with the United States Government, do not constitute sales to the United States Government.

Example 1: A taxpayer contracts with General Services Administration to deliver X number of trucks which were paid for by the United States Government. The sale is a sale to the United States Government.

Example 2: The taxpayer, as a subcontractor to a prime contractor with the National Aeronautics and Space Administration, contracts to build a component of a rocket for $1,000,000. The sale by the subcontractor to the prime contractor is not a sale to the United States Government. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-36)

HRS §235-37 **§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 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.

(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:

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

(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:

$$\frac{200}{600} \text{ x } \$9{,}000 = \$3{,}000$$

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

HRS §235-38 **§18-235-38-01 Equitable adjustment of apportionment formula.** (a) If the director determines that the apportionment formula prescribed by section 235-29, HRS, does not fairly determine net income derived from or attributable to Hawaii, the director may direct or permit the use of an apportionment formula based on other factors that would more clearly reflect income attributable to Hawaii.

(b) A taxpayer may petition the director to use an allocation or apportionment method other than that prescribed in part II of chapter 235, HRS, by written request.

(1) The petition shall include data clearly showing that the application of factors provided in the law, including these rules, do not result in a reasonable attribution of net income to Hawaii due to the peculiar nature of the taxpayer's business and that the taxpayer's proposed method more clearly reflects income attributable to Hawaii.

(2) The petition shall disclose whether the method that is being used or requested is being employed in all other states to which the taxpayer reports under Article IV of the Multistate Tax Compact or the Uniform Division of Income for Tax Purposes Act. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §§235-38, 235-117)

HRS §235-38 **§18-235-38-02 Special rules; property factor.** (a) If the subrents taken into account in determining the net annual rental rate under section 18-235-31-02 produce a negative or clearly inaccurate value for any item of property, another method which will properly reflect the value of rented property may be required by the department or requested by the taxpayer.

In no case, however, shall the value be less than an amount which bears the same ratio to the annual rental rate paid by the taxpayer for the property as the fair market value of that portion of the property used by the taxpayer bears to the total fair market value of the rented property.

Example: The taxpayer rents a ten-story building at an annual rental rate of $1,000,000. Taxpayer occupies two stories and sublets eight stories for $1,000,000 a year. The net annual rental rate of the taxpayer must not be less than two-tenths of the taxpayer's annual rental rate for the entire year, or $200,000.

(b) If property owned by others is used by the taxpayer at no charge or rented by the taxpayer for a nominal rate, the net annual rental rate for the property shall be determined on the basis of a reasonable market rental rate for the property. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §§235-31, 235-38)

HRS §235-38 **§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)).

(e) Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income 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 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] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §§235-35 to 235-38)

HRS §235-38 **§18-235-38-04 Allocation of income and deductions among taxpayers.** (a) If two or more organizations, trades, or businesses, whether or not incorporated or organized in Hawaii, are owned or controlled directly or indirectly by the same interests, the director may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among the organizations, trades, or businesses if the director determines that the distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or to clearly reflect the income attributable to any taxpayer's activity in Hawaii.

(b) This section shall not be construed to permit the filing of consolidated returns by two or more affiliated corporations except as provided by section 235-92, HRS.

(c) The director shall not allocate or apportion income to Hawaii in excess of what is considered just and reasonable under the circumstances. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118, 235-38) (Imp: HRS §235-38, IRC §482)

Historical note: §18-235-38-04 is based substantially upon §18-235-5-04. [Eff 2/16/82; am and ren §18-235-5-04 9/3/94]

HRS §235-38 **§18-235-38-05 Apportionment method considered method of accounting.** (a) A taxpayer's change in any of the following shall be a change in the taxpayer's method of accounting within the meaning of sections 446 (with respect to methods of accounting) and 481 (with respect to adjustments required by changes in method of accounting), IRC, as operative under chapter 235, HRS:

(1) The manner of prorating any item of deduction among the classes of income to which it is applicable. See section 18-235-21-04.
(2) The manner in which income is classified as business income or nonbusiness income. See section 18-235-22-05.
(3) The manner of valuing property, or of excluding or including property in the property factor. See section 18-235-30-03.
(4) The treatment of compensation paid. See section 18-235-33-01.
(5) The manner of excluding or including gross receipts in the sales factor. See section 18-235-35-01.
(6) The apportionment formula employed. See section 18-235-38-01.
(7) Whether the taxpayer is employing a combined reporting method. See section 18-235-22-03.

(b) In order to secure the department's consent to a change in any of the items set forth in subsection (a), the taxpayer shall file a written application with the department within one-hundred-eighty days after the beginning of the taxable year in which it is desired to make the change.

(1) The taxpayer, to the extent applicable, shall (A) disclose in detail all classes of items which would be treated differently as a result of the proposed change, (B) state the reasons for making the change, and (C) furnish the taxpayer's computation of any applicable adjustments to take into account any duplications or omissions.
(2) The department may require such other information as may be necessary in order to determine whether the proposed change will be permitted.
(3) Permission shall not be granted unless the taxpayer and the department agree to the terms, conditions, and adjustments, if any, under which the change will be effected.
(4) Within one-hundred-eighty days after receiving the application, the department shall grant or deny the application. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-38, IRC §§446, 481)

HRS §235-38 **§18-235-38-06 Apportionment of income for special industries.** The director finds that neither the apportionment formula of section 235-29, HRS, nor the separate accounting method clearly or accurately reflects the correct taxable income in Hawaii of taxpayers doing business within and without Hawaii in the industries listed in the following table. Accordingly, income of these taxpayers shall be apportioned using the methods in the section listed opposite the name of the industry in the following table.

Special industry	Section
Air carriers	18-235-38-06.02
Construction contractors	18-235-38-06.03
Ocean carriers	18-235-38-06.01
Publishing	18-235-38-06-05
Radio broadcasting	18-235-38-06.04
Television broadcasting	18-235-38-06.04

[Eff 9/3/94; am 3/11/96, 7/25/98] (Auth: HRS §§231-3(9), 235-118, 235-38) (Imp: HRS §235-38)

Historical note: §18-235-38-06 is based substantially upon §18-235-5(b)(2). [Eff 2/16/82; am and ren 9/3/94]

HRS §235-38 **§18-235-38-06.01 Apportionment of income for ocean carriers.** (a) As used in this section:

"Originating revenue within this State" means revenue to an ocean carrier from the transportation of revenue passengers and revenue cargo first received by the carrier either as originating or connecting traffic at ports within the State.

"Revenue tons handled", for an ocean carrier at a port, mean the weight in tons of revenue passengers (at five hundred pounds per passenger) and revenue cargo first received as originating or connecting traffic, or finally discharged by the carrier at the port.

"Voyage hours" mean the total hours the ocean carrier's vessels have spent over the high seas plus the hours spent in port. Voyage hours do not include hours when vessels are withheld from service because of strikes, repairs or maintenance, acts of God, or seasonal reduction of service.

(b) Business income of an ocean carrier shall be apportioned to Hawaii by multiplying the income by a fraction, the denominator of which is three and the numerator of which is the sum of the following three ratios:

(1) The ratio of revenue tons handled by the ocean carrier at ports within this State during the taxable year to the total revenue tons handled by the carrier at ports within and without this State during the same period;

(2) The ratio of the ocean carrier's originating revenue within this State for the taxable year to the carrier's total originating revenue within and without this State for the same period; and

(3) The ratio of the ocean carrier's voyage hours within this State for the taxable year to the carrier's total voyage hours within and without this State for the same period.

(c) For an ocean carrier incorporated in Hawaii, the numerator in each of the ratios in subsection (b)(1), (2), and (3) shall include that portion of revenue tons, originating revenues, and voyage hours attributable to jurisdictions in which the ocean carrier is not taxable. [Eff 9/3/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §235-38)

Historical note: §18-235-38-06.01 is based substantially upon §18-235-5(e)(5)(A). [Eff 2/16/82; am and ren 9/3/94]

HRS §235-38 **§18-235-38-06.02 Apportionment of income for air carriers.** (a) As used in this section:

"Flight operating hours" mean the normal air and ground hours of aircraft of an air carrier in scheduled flights and nonscheduled operations. Flight operating hours do not include time spent for repairs and maintenance and delays caused by abnormal events such as strikes, acts of God, and weather conditions.

"Originating revenue within this State" means revenue from the transportation of revenue passengers and revenue cargo that are first received by the air carrier either as originating or connecting traffic at airports within the State.

(1) Originating revenue includes revenue from the carriage of express and mail.

(2) Originating revenue does not include passenger receipts that will be turned over to another air carrier as its share of the total passenger receipts.

"Revenue tons handled", by an air carrier at an airport, mean the weight in tons of revenue passengers (at two hundred pounds per passenger) and revenue cargo first received as originating or connecting traffic, or finally discharged by the air carrier at the airport.

(1) Revenue tons handled includes express and mail tonnage.

(2) For purposes of computing revenue tons handled, revenue passengers do not include those passengers making transfers on connecting flights of the same carrier; however, passengers making voluntary stopovers at a connecting point for twenty-four hours or more shall not be considered to be making connecting flights.

(b) Business income of an air carrier shall be apportioned to Hawaii by multiplying the income by a fraction, the denominator of which is three and the numerator of which is the sum of the following three ratios:

(1) The ratio of the revenue tons handled by the air carrier at airports within this State during the taxable year to the total revenue tons handled at airports within and without this State during the same period;

(2) The ratio of the air carrier's originating revenue within this State for the taxable year to the total originating revenue within and without this State for the same period; and

(3) The ratio of the air carrier's flight operating hours within this State for the taxable year to the total flight operating hours within and without this State for the same period.

(c) For an air carrier incorporated in Hawaii, the numerator in each of the ratios in subsection (b)(1), (2), and (3) shall include that portion of revenue tons, originating revenues, and flight operating hours attributable to jurisdictions in which the air carrier is not taxable. [Eff 9/3/94] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §235-38)

Historical note: §18-235-38-06.02 is based substantially upon §18-235-5(e)(5)(B). [Eff 2/16/82; am and ren 9/3/94]

HRS §235-38 **§18-235-38-06.03 Construction contractors.** (a) These rules apply to a taxpayer that uses the percentage of completion method or the completed contract method to account for income from long-term contracts (construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted).

(1) Every taxpayer shall determine how much of the taxpayer's income for the year constitutes nonbusiness income, and how much constitutes business income, under section 235-21, HRS, and the rules that interpret that section.

(2) Nonbusiness income is directly allocated to Hawaii under sections 235-25 to 235-28, HRS, and the rules that interpret those provisions.

(3) For a taxpayer using the percentage of completion method described in subsection (d)(2), the taxpayer's business income (including income from long-term contracts that is allocable to the year) is apportioned to Hawaii using the three-factor formula in section 235-29, HRS, where the factors are modified as follows:

(A) The rules in subsection (d)(4) apply to the property factor, in order to take into account the taxpayer's investment in a construction project in progress;

(B) The rules in subsection (d)(5) apply to the payroll factor; and

(C) The rules in subsection (d)(6), including subsection (d)(6)(B), apply to the sales factor in order to take into account receipts from long-term contracts.

(4) For a taxpayer using the completed contract method described in subsection (d)(3):

(A) The taxpayer's business income (not including business income from long-term contracts) is apportioned to Hawaii using the three-factor formula in section 235-29, HRS, where the factors are modified as follows:

(i) The rules in subsection (d)(4) modify the property factor to take into account the taxpayer's investment in a construction project in progress;

(ii) The rules in subsection (d)(5) apply to the payroll factor; and

(iii) The rules in subsection (d)(6), including subsection (d)(6)(C), apply to the sales factor in order to take into account receipts from long-term contracts; and

(B) Business income from each long-term contract is separately apportioned as follows:

(i) Income from each long-term contract completed during the year is apportioned to Hawaii using the method described in subsection (e), which uses a weighted average of the factors determined under subparagraph (A) for each year the contract was in progress;

(ii) If the taxpayer dissolves, withdraws, or otherwise ceases doing business in Hawaii during the year, income from each incomplete contract shall be taken into account and apportioned to Hawaii using the method described in subsection (f), which uses a weighted average of the factors determined under subparagraph (A) for each year the contract was in progress; or

(iii) Otherwise, income from each long-term contract that is not completed during the year is not taken into account in that year.

(5) The sum of:

(A) The items of nonbusiness income directly allocated to Hawaii under paragraph (2), and

(B) The amount of business income apportioned to Hawaii under paragraph (3) or (4),

is the amount of the taxpayer's income that is subject to net income tax by Hawaii.

(b) For definitions, rules, and examples for determining business and nonbusiness income, see section 235-21, HRS, and the rules that interpret that section.

(c) For general rules of accounting, definitions, and methods of accounting for long-term construction contracts see sections 446 (relating to methods of accounting generally) and 460 (relating to the general requirement that the percentage of completion method be used) of the Internal Revenue Code of 1986, as amended, as operative under chapter 235, HRS; and Treasury Regulations section 1.451-3.

(d) The following rules apply to apportionment of business income.

(1) Business income is apportioned to Hawaii by a three-factor formula consisting of property, payroll, and sales regardless of the method of accounting for long-term contracts elected by the taxpayer. The total of the property, payroll, and sales percentages is divided by three to determine the apportionment percentage. The apportionment percentage then is applied to business income to determine the amount apportioned to Hawaii.

(2) Under the percentage of completion method of accounting for long-term contracts, the amount to be included each year as business income from each contract is the amount by which the gross contract price corresponding to the percentage of the entire contract that has been completed during the income year exceeds all expenditures made during the income year in connection with the contract. In so doing, account must be taken of the material and supplies on hand at the beginning and end of the income year for use in each long-term contract.

Example: A taxpayer using the percentage of completion method of accounting for long-term contracts entered into a long-term contract to build a structure for $9,000,000. The contract allowed three years for completion and, as of the end of the second income year, the taxpayer's books of account, kept on the accrual method, disclosed the following:

	Receipts	Expenditures
End of 1st income year	$2,500,000	$2,400,000
End of 2nd income year	4,500,000	4,100,000
Totals	$7,000,000	$6,500,000

In computing the above expenditures, consideration was given to material and supplies on hand at the beginning and end of each income year. It was estimated that the contract was 30 per cent completed at the end of the first income year and (because of change orders given during the second income year) 80 per cent completed at the end of the second income year. The amount to be included as business income for the first income year is $300,000 (30 per cent of $9,000,000 or $2,700,000, less expenditures of $2,400,000, equals $300,000). The amount to be included as business income for the second income year is $400,000 (50 per cent of $9,000,000 or $4,500,000, less expenditures of $4,100,000, equals $400,000).

If a taxpayer has made the election under section 460(b)(5) of the Internal Revenue Code (under which a taxpayer does not take into account income with respect to a contract under the percentage of completion method until the income year as of the close of which at least 10 per cent of the estimated total contract costs have been incurred), then with respect to each contract to which the election is effective:

(A) The property, payroll, and sales factors shall be computed as set forth in this section the same as if the election had not been made;

(B) Income from the contract for the 10 per cent year is apportioned to Hawaii using the methodology described in subsection (e), which uses a weighted average of the property, payroll, and sales factors for the 10 per cent year and all prior income years in which the contract was in progress; and

(C) Where the taxpayer dissolves, withdraws, or otherwise ceases doing business in Hawaii during a year prior to the 10 per cent year, the taxpayer shall take into account income with respect to the contract, and the income shall be apportioned to Hawaii, using the method described in subsection (f), which uses a weighted average of the property, payroll, and sales factors for all income years in which the contract was in progress.

(3) Under the completed contract method of accounting, business income derived from long-term contracts is reported for the income year in which the contract is finally completed and accepted. Therefore, a special computation is required to compute the amount of business income attributable to Hawaii from each completed contract (see subsection (e)). Thus, all receipts and expenditures applicable to those contracts, whether complete or incomplete as of the end of the income year, are apportioned separately from business income derived from other sources, such as short-term contracts, interest, rents, or royalties, which are apportioned by the regular three-factor formula of property, payroll, and sales.

(4) In general, the numerator and denominator of the property factor shall be determined as set forth in sections 235-30 to 235-32, HRS, and the rules that interpret those provisions. However, the following special rules also are applicable:

(A) The average value of the taxpayer's cost (including materials and labor) of construction in progress, to the extent the costs exceed progress billings (accrued or received, depending on whether the taxpayer is on the accrual or cash basis for keeping its accounts) shall be included in the denominator of the property factor. The

value of any such construction costs attributable to construction projects in Hawaii shall be included in the numerator of the property factor.

Example 1: Taxpayer commenced a long-term construction project in Hawaii as of the beginning of a given income year. By the end of its second year, its equity in the costs of production to be reflected in the numerator and denominator of its property factor for that year is computed as follows:

	1st Year		2nd Year	
	Beginning	Ending	Beginning	Ending
Construction Costs	$1,000,000			
Progress Billings		600,000		
Balance 12/31 - (1/1)		$400,000	$400,000	
Construction Costs -				
Total from beginning of project				$5,000,000
Progress billings -				
Total from beginning of project				4,000,000
Balance 12/31				1,000,000
Balance beginning of year				400,000
Total				$1,400,000
Average (1/2) (Note 1) -				
Value used in property factor				$ 700,000

Note 1 - It may be necessary to use monthly averages if yearly averages do not properly reflect the average value of the taxpayer's equity. See section 235-32, HRS, and the rules that interpret that section.

Example 2: Same facts as in Example 1, except that progress billings exceeded construction costs. No value for the taxpayer's equity in the construction project is shown in the property factor.

(B) Rent paid for the use of equipment directly attributable to a particular construction project is included in the property factor at eight times the net annual rental rate even though the rental may be capitalized into the cost of construction.

(C) The property factor is computed in the same manner for all long-term contract methods of accounting and is computed for each income year even though under the completed contract method of accounting, business income is computed separately (see subsection (e)).

(5) In general the numerator and denominator of the payroll factor shall be determined as set forth in sections 235-33 and 235-34, HRS, and the rules that interpret those provisions. However, the following special rules also are applicable:

(A) Compensation paid employees which is attributable to a particular construction project is included in the payroll factor even though capitalized into the cost of construction.

(B) Compensation paid employees who in the aggregate perform most of their services in a state other than the state to which their employer reports them for unemployment tax purposes, shall nevertheless be attributed to the state in which the services are performed.

Example: A taxpayer engaged in a long-term contract in state X sends several key employees to that state to supervise the project. The taxpayer, for unemployment tax purposes, reports these employees to state Y where the main office is maintained and where the employees reside. For payroll factor purposes, the compensation is assigned to the numerator of state X.

(C) The payroll factor is computed in the same manner for all long-term contract methods of accounting and is computed for each income year even though, under the completed contract method of accounting, business income is computed separately (see subsection (e)).

(6) In general, the numerator and denominator of the sales factor shall be determined as set forth in sections 235-35 to 235-37, HRS, and the rules that interpret those provisions. However, the following special rules also are applicable:

(A) Gross receipts derived from the performance of a contract are attributable to Hawaii if the construction project is located in Hawaii. If the construction project is located partly within and partly without Hawaii, the gross receipts attributable to Hawaii are based upon the ratio which construction costs for the project in Hawaii incurred during the income year bear to the total of construction costs for the entire project during the income year. Any other method, such as engineering cost estimates, may be used if it provides a reasonable apportionment.

Example: A construction project was undertaken in Hawaii by a calendar year taxpayer which had elected one of the long-term contract methods of accounting. The following gross receipts (progress billings) were derived from the contract during the three income years that the contract was in progress.

	1st Year	2nd Year	3rd Year
Gross Receipts	$1,000,000	$4,000,000	$3,000,000

The gross receipts to be reflected in both the numerator and denominator of the sales factor for each of the three years are the amounts shown.

(B) If the percentage of completion method is used, the sales factor includes only that portion of the gross contract price which corresponds to the percentage of the entire contract which was completed during the income year.

Example: A taxpayer which had elected the percentage of completion method of accounting entered into a long-term construction contract. At the end of its current income year (the second since starting the project), it estimated that the project was 30 per cent completed. The bid price for the project was $9,000,000 and it had received $2,500,000 from progress billings as of the end of its current income year. The amount of gross receipts to be included in the sales factor for the current income year is $2,700,000 (30 per cent of $9,000,000), regardless of whether the taxpayer uses the accrual method or the cash method of accounting for receipts and disbursements.

(C) If the completed contract method of accounting is used, the sales factor includes the portion of the gross receipts (progress billings) received or accrued, whichever is applicable, during the income year attributable to each contract.

Example 1: A taxpayer which had elected the completed contract method of accounting entered into a long-term construction contract. By the end of its current income year (the second since starting the project), it had billed, and had accrued on its books, a total of $5,000,000. Of that amount, $2,000,000 had accrued in the first year in which the contract was undertaken, and $3,000,000 had accrued in the current (second) year. The amount of gross receipts to be included in the sales factor for the current income year is $3,000,000.

Example 2: Same facts as in Example 1 except that the taxpayer keeps its books on the cash basis and, as of the end of its current income year, had received only $2,500,000 of the $3,000,000 billed during the current year. The amount of gross receipts to be included in the sales factor for the current income year is $2,500,000.

(D) The sales factor, except as noted above in subparagraphs (B) and (C), is computed in the same manner regardless of which long-term method of accounting the taxpayer has elected, and is computed for each income year even though, under the completed contract method of accounting, business income is computed separately.

(7) The total of the property, payroll, and sales percentages is divided by three to determine the apportionment percentage. The apportionment percentage then is applied to business income to establish the amount apportioned to Hawaii.

(e) The completed contract method of accounting requires that the reporting of income (or loss) be deferred until the year in which the construction project is completed or accepted. Accordingly, a separate computation is made for each such contract completed during the income year, regardless of whether the project is located within or without Hawaii, in order to determine the amount of income which is attributable to sources within Hawaii. The amount of income from each contract completed during the income year apportioned to Hawaii, plus other business income apportioned to Hawaii by the regular three-factor formula (such as interest income, rents, royalties, or income from short-term contracts), plus all nonbusiness income allocated to Hawaii, is the measure of tax for the income year. The amount of income (or loss) from each contract which is derived from sources within Hawaii using the completed contract method of accounting is computed as follows:

(1) In the income year in which the contract is completed, the income (or loss) from the contract is determined.

(2) The income (or loss) determined at paragraph (1) is apportioned to Hawaii by the following method:

(A) A fraction is determined for each year the contract was in progress. The numerator is the amount of construction costs paid or accrued in each year the contract was in progress and the denominator is the total of all construction costs for the project.

(B) Each percentage determined in (A) is multiplied by the apportionment formula percentage for that particular year as determined in subsection (d)(7).

(C) The percentages determined in (B) for each year during which the contract was in progress are totaled. The amount of total income (or loss) from the contract determined in paragraph (1) is multiplied by the total percentage. The resulting income (or loss) is the amount of business from such contract derived from sources within Hawaii.

Example 1: A taxpayer using the completed contract method of accounting for long-term contracts is engaged in three long-term contracts: Contract L in Hawaii, Contract M in state X and Contract N in state Y. In addition, it has other business income (less expenses) during the income year 1992 from interest, rents, and short-term contracts amounting to $500,000, and nonbusiness income allocable to Hawaii of $8,000. During 1992, it completed Contract M in state X at a profit of $900,000. Contracts L and N in Hawaii and state Y, respectively, were not completed during the income year. The apportionment percentages of the taxpayer as determined in subsection (d)(7) and the percentages of contract costs as determined in this paragraph for each year during which Contract M in state X was in progress are as follows:

	1990	1991	1992
Apportionment %	30%	20%	40%
% of Construction costs of Contract M each year to total construction costs - (100%)	20%	50%	30%

The corporation's net income subject to tax in Hawaii for 1992 is computed as follows:

Business Income	$500,000
Apportion 40% to Hawaii	200,000
Add: Income from Contract M (Note 1)	252,000
Total business income derived from sources within Hawaii	452,000
Add: Nonbusiness income allocated to Hawaii	8,000
Net income subject to tax	$460,000

Note 1 - Income from Contract M apportioned to Hawaii:

	1990	1991	1992	Total
Apportionment %	30%	20%	40%	
% of Construction Costs	20%	50%	30%	100%
Product	6%	10%	12%	28%

28% of $900,000 = $252,000

Example 2: Same facts as in Example 1 except that Contact L was started in 1992 in Hawaii, the first year in which the taxpayer was subject to tax in Hawaii. Contract

L in Hawaii and Contract N in state Y are incomplete in 1992. The corporation's net income subject to tax in Hawaii for 1992 is computed as follows:

Business Income	$500,000
Apportion 40% to Hawaii	200,000
Add: Income from Contract M (Note 1)	108,000
Total business income derived from sources within Hawaii	308,000
Add: Nonbusiness income allocated to Hawaii	8,000
Net Income subject to tax	$316,000

Note 1 - Income from Contract M apportioned to Hawaii:

	1990	1991	1992	Total
Apportionment %	-0-	-0-	40%	
Costs	20%	50%	30%	100%
Product	-0-	-0-	12%	12%

12% of $900,000 = $108,000

Here, only 12 per cent is used to determine the income derived from sources within Hawaii since the corporation was not subject to tax in Hawaii prior to 1992.

Example 3: Same facts as in Example 1 except that the figures relate to Contract L in Hawaii and 1992 is the first year the corporation was taxable in another state (see sections 235-22 and 235-23, HRS, and the rules that interpret those provisions). Contracts M and N in states X and Y were started in 1992 and are incomplete. The corporation's net income subject to tax in Hawaii for 1992 is computed as follows:

Business Income	$500,000
Apportion 40% to Hawaii	200,000
Add: Income from Contract L (Note 1)	738,000
Total business income derived from sources within Hawaii	938,000
Add: Nonbusiness income allocated to Hawaii	8,000
Net income subject to tax	$946,000

Note 1 - Income from Contract L apportioned to Hawaii:

	1990	1991	1992	Total
Apportionment %	100%	100%	40%	
% of Construction Costs	20%	50%	30%	100%
Product	20%	50%	12%	82%

82% of $900,000 = $738,000

(f) Use of the completed contract method of accounting for long-term contracts requires that income derived from sources within Hawaii from incomplete contracts in progress outside Hawaii on the date of withdrawal, dissolution, or cessation of business in Hawaii be included in the measure of tax for the taxable year during which the corporation withdraws, dissolves, or ceases doing business in Hawaii.

The amount of income (or loss) from each contract to be apportioned to Hawaii by the apportionment method set forth in subsection (e)(2) shall be determined as if the percentage of completion method of accounting were used for all contracts on the date of withdrawal, dissolution, or cessation of business. The amount of business income (or loss) for each contract shall be the amount by which the gross contract price from each contract which corresponds to the percentage of the entire contract which has been completed from the commencement of the contract to the date of withdrawal, dissolution, or cessation of business exceeds all expenditures made during that period in connection with each contract. In so doing, account must be taken of the material and supplies on hand at the beginning and end of the income year for use in each contract.

Example: A construction contractor qualified to do business in Hawaii had elected the completed contract method of accounting for long-term contracts. It was engaged in two long-

term contracts. Contract L in Hawaii was started in 1991 and completed at a profit of $900,000 on December 16, 1993. The taxpayer withdrew on December 31, 1993. Contract M in state X was started in 1992 and was incomplete on December 31, 1993. The apportionment percentages of the taxpayer, as determined in subsection (d), and percentages of construction costs, as determined in subsection (e)(2), for each year for each contract are as follows:

	1991	1992	1993	Total
Apportionment %	30%	20%	40%	
% of Construction Costs:				
Contract L, Hawaii	20%	50%	30%	100%
Contract M, state X	-0-	10%	25%	35%

The corporation had other business income (net of expenses) of $500,000 during 1992 and $300,000 during 1993. The gross contract price of Contract M (state X) was $1,000,000, and it was estimated to be 35 per cent completed on December 31, 1993. Total expenditures to date for Contract M (state X) were $300,000 for the period ended December 31, 1993. The measure of tax for the taxable year ended December 31, 1993 is computed as follows:

	Taxable Year 1993	
	Income Year 1992	Income Year 1993
Business Income	$500,000	$300,000
Apportionment % to Hawaii	20%	40%
Amount apportioned to Hawaii	100,000	120,000
Add: Income from contracts:		
L (Hawaii) (Note 1)		252,000
M (state X) (Note 2)		6,000
Total business income derived from sources within Hawaii	$100,000	$378,000

Note 1 - Income from Contract L apportioned to Hawaii:

	1991	1992	1993	Total
Apportionment %	30%	20%	40%	
% of Construction Costs	20%	50%	30%	100%
Product	6%	10%	12%	28%

28% of $900,000 = $252,000

Note 2 - Income from Contract M apportioned to Hawaii:

	1991	1992	1993	Total
Apportionment %	-0-	20%	40%	
% of Construction Costs	-0-	10%	25%	35%
Product	-0-	2%	10%	12%

12% of 50,000 (Note 3) = $6,000

Note 3 - Computation of apportionable income from Contract M based on percentage of completion method:

Total Contract Price	$1,000,000
Estimated to be 35% completed	350,000
Less: Total expenditures to date	300,000
Apportionable income	$ 50,000

[Eff 3/11/96] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §235-38)

HRS §235-38 **§18-235-38-06.04 Television and radio broadcasting.** (a) When a person in the business of broadcasting film or radio programming, whether through the public airwaves, by cable, direct or indirect satellite transmission, or any other means of communication, either through a network (including owned and affiliated stations) or through an affiliated, unaffiliated, or independent television or radio broadcasting station, has income

from sources both within and without Hawaii, the amount of business income from sources within Hawaii shall be determined pursuant to sections 235-21 to 235-39, HRS, or the Multistate Tax Compact (section 255-1, HRS), except as modified by this section.

(b) For definitions, rules, and examples for determining whether income shall be classified as business or nonbusiness income, see sections 18-235-21-01 to 18-235-21-04.

(c) In this section, unless the context clearly requires otherwise:

"Film" or "film programming" means any and all performances, events, or productions telecast on television, including news, sporting events, plays, stories, or other literary, commercial, educational, or artistic works, through the use of video tape, disc, or any other type of format or medium.

Each episode of a series of films produced for television shall constitute a separate film notwithstanding that the series relates to the same principal subject and is produced during one or more tax periods.

"Outer-jurisdictional property" means tangible personal property, such as orbiting satellites, undersea transmission cables, and the like, that are owned or rented by the taxpayer and used in the business of telecasting or broadcasting, but that are not physically located in any particular state.

"Radio" or "radio programming" means any and all performances, events, or productions that are broadcast on radio, including news, sporting events, plays, stories, or other literary, commercial, educational, or artistic works, through the use of an audio tape, disc, or any other format or medium.

Each episode of a series of radio programming produced for radio broadcast shall constitute a separate radio programming notwithstanding that the series relates to the same principal subject and is produced during one or more tax periods.

"Release" or "in release" means the placing of film or radio programming into service. A film or radio program is placed into service when it is first broadcast to the primary audience for which the program was created. Thus, for example, a film is placed in service when it is first publicly telecast for entertainment, educational, commercial, artistic, or other purposes. Each episode of a television or radio series is placed in service when it is first broadcast. A program is not placed in service merely because it is completed and therefore is in a condition or state of readiness and availability for broadcast, or merely because it is previewed to prospective sponsors or purchasers.

"Rent" includes license fees or other payments or consideration provided in exchange for the broadcast or other use of film or radio programming.

"State" includes the District of Columbia, the Commonwealth of Puerto Rico, or any possession or territory of the United States.

A "subscriber" to a cable television system is the individual residence or other outlet which is the ultimate recipient of the transmission.

"Telecast" or "broadcast" (sometimes used interchangeably with respect to television) means the transmission of television or radio programming, respectively, by an electronic or other signal conducted by radio waves, microwaves, wires, lines, coaxial cables, wave guides, fiber optics, satellite transmissions, or by any other means, directly or indirectly to viewers or listeners.

(d) The property factor shall be determined in accordance with sections 235-30 to 235-32, HRS, and the rules thereunder; the payroll factor in accordance with sections 235-33 to 235-34, HRS, and the rules thereunder; and the sales factor in accordance with sections 235-35 to 235-37, HRS, and the rules thereunder; except as modified by this section.

(e) The following rules relate to the property factor.

(1) The following rules apply with respect to the property factor in general.

(A) In the case of rented studios, the net annual rental rate shall include only the amount of the basic or flat rental charge by the studio for the use of a stage or other permanent equipment such as sound recording equipment and the like; except that additional equipment rented from other sources or from the studio not covered in the basic or flat rental charge and used for one week or longer (even though rented on a day-to-day basis) shall be included. Lump-sum net rental payments for a period which encompasses more than a single income year shall be assigned ratably over the rental period.

(B) No value or cost attributable to any outer-jurisdictional and film or radio programming property shall be included in the property factor.

(2) The following rules apply with respect to the property factor denominator.

(A) All real property and tangible personal property (other than outer-jurisdictional and film or radio programming property), whether owned or rented, that is used in the business shall be included in the denominator of the property factor.

(B) Audio or video cassettes, discs, or similar media containing film or radio programming and intended for sale or rental by the taxpayer for home viewing or listening shall be included in the property factor at their original cost. To the extent that the taxpayer

licenses or otherwise permits others to manufacture or distribute cassettes, discs, or other media containing film or radio programming for home viewing or listening, the value of the cassettes, discs, or other media shall include the license, royalty, or other fees received by the taxpayer capitalized at a rate of eight times the gross receipts derived therefrom during the income year.

(C) Outer-jurisdictional and film or radio programming property shall be excluded from the denominator of the property factor.

(3) The following rules apply with respect to the property factor numerator.

(A) With the exception of outer-jurisdictional and film or radio programming property, all real and tangible personal property owned or rented by the taxpayer and used in Hawaii during the tax period shall be included in the numerator of the property factor as set forth in section 18-235-30-04.

(B) Outer-jurisdictional and film or radio programming property shall be excluded from the numerator of the property factor.

Example: XYZ Television Co. has a total value of all of its property everywhere of $500,000,000, including a satellite valued at $50,000,000 that was used to telecast programming into Hawaii and $150,000,000 in film property of which $1,000,000 worth was located in Hawaii the entire year. The total value of real and tangible personal property, other than film programming property, located in Hawaii for the entire income year was valued at $2,000,000. The movable and mobile property described in subparagraph (e)(3)(A) has a value of $4,000,000. That property was used in Hawaii for 100 days. The property factor is determined as follows:

Value of property permanently in Hawaii:		$2,000,000
Value of mobile and movable property (100/365 x $4,000,000):		1,095,600
Total value of property to be included in Hawaii's property factor numerator without apportionment of outer-jurisdictional and film property:		$3,095,600
Total value of property everywhere:	$500,000,000	
Less value of satellite:		(50,000,000)
Less value of film property:		(150,000,000)
Total value of property to be used in denominator:		$300,000,000
Property factor ($3,095,600/$300,000,000):		.0103

(f) The following rules relate to the payroll factor.

(1) The denominator of the payroll factor shall include all compensation, including residual and profit participation payments, paid to employees during the income year, including that paid to directors, actors, newscasters, and other talent in their status as employees.

(2) With respect to the payroll factor numerator, compensation for all employees shall be attributed to the state or states as may be determined under sections 18-235-33-01 to 18-235-34-01.

(g) The following rules relate to the sales factor.

(1) The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under section 18-235-38-03.

(2) The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within Hawaii, including the following.

(A) Gross receipts, including advertising revenue, from television, film, or radio programming in release to or by a television station (independent or unaffiliated) or network of stations for broadcast shall be attributed to Hawaii in the ratio (hereafter "audience factor") that the audience for the station (or owned and affiliated stations

in the case of networks) located in Hawaii bears to the total audience for the station (or owned and affiliated stations in the case of networks). The audience factor for television or radio programming shall be determined by the ratio that the taxpayer's in-state viewing (listening) audience bears to its total viewing (listening) audience. The audience factor shall be determined either by reference to the books and records of the taxpayer or by reference to published rating statistics, provided the method used by the taxpayer is consistently used from year to year for this purpose and fairly reflects the taxpayer's activity in Hawaii.

(B) Gross receipts from film programming in release to or by a cable television system shall be attributed to Hawaii in the ratio (hereafter "audience factor") that the subscribers for such cable television system located in Hawaii bears to the total subscribers of such cable television system. If the number of subscribers cannot be accurately determined from the books and records maintained by the taxpayer, the audience factor ratio shall be determined on the basis of the applicable year's subscription statistics located in published surveys, provided that the source selected is consistently used from year to year for that purpose.

(C) Receipts from the sale, rental, licensing, or other disposition of audio or video cassettes, discs, or similar media intended for home viewing or listening shall be included in the sales factor as provided in sections 235-36 and 235-37, HRS, and the rules thereunder. [Eff 7/25/98] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §235-38)

HRS §235-38 **§18-235-38-06.05 Publishing.** (a) Except as specifically modified in this section, when a person in the business of publishing, selling, licensing, or distributing newspapers, magazines, periodicals, trade journals, or other printed material has income from sources both within and without Hawaii, the amount of business income from sources within Hawaii from that business activity shall be determined pursuant to sections 235-21 to 235-39, HRS, or the Multistate Tax Compact (section 255-1, HRS), except as modified by this section.

(b) In this section, unless the context clearly requires otherwise:

"Outer-jurisdictional property" means tangible personal property, such as orbiting satellites, undersea transmission cables, and the like, that are owned or rented by the taxpayer and used in the business of publishing, licensing, selling, or otherwise distributing printed material, but are not physically located in any particular state.

"Print or printed material" includes the physical embodiment or printed version of any thought or expression, such as a play, story, article, column, or other literary, commercial, educational, artistic, or other written or printed work. The determination of whether an item is, or consists of, print or printed material shall be made without regard to its content. Printed material may take the form of a book, newspaper, magazine, periodical, trade journal, or any other form of printed matter, and may be contained on any medium or property.

"Purchaser" and "subscriber" mean the individual, residence, business, or other outlet which is the ultimate or final recipient of the print or printed material. Neither of these terms includes a wholesaler or other distributor of print or printed material.

"Terrestrial facility" shall include any telephone line, cable, fiber optic, microwave, earth station, satellite dish, antenna, or other relay system or device that is used to receive, transmit, relay, or carry any data, voice, image, or other information that is transmitted from or by any outer-jurisdictional property to the ultimate recipient of the information.

(c) Business income shall be apportioned using the following rules.

(1) The following rules relate to the property factor.

(A) All real property and tangible personal property, including outer-jurisdictional property, whether owned or rented, that are used in the business shall be included in the denominator of the property factor.

(B) The following rules relate to the property factor numerator.

(i) All real and tangible personal property owned or rented by the taxpayer and used in Hawaii during the tax period shall be included in the numerator of the property factor.

(ii) Outer-jurisdictional property owned or rented by the taxpayer and used in Hawaii during the tax period shall be included in the numerator of the property factor in the ratio that the value of the property attributable to its use by the taxpayer in business activities in Hawaii bears to the total value of the property attributable to its use in the taxpayer's business activities everywhere.

The value of outer-jurisdictional property to be attributed to the numerator of the property factor of Hawaii shall be determined by the ratio that the number of uplinks and downlinks (sometimes referred to as "half-circuits") that were

used during the tax period to transmit from Hawaii and to receive in Hawaii any data, voice, image, or other information bears to the total number of uplinks and downlinks, or half-circuits, that the taxpayer used for transmissions everywhere. If information regarding uplink and downlink or half-circuit usage is not available, or if that measurement of activity is not applicable to the type of outer-jurisdictional property used by the taxpayer, the value of such property to be attributed to the numerator of the property factor of Hawaii shall be determined by the ratio that the amount of time (in terms of hours and minutes of use), or any other measurement of use of outer-jurisdictional property that was used during the tax period to transmit from Hawaii and to receive in Hawaii any data, voice, image, or other information, bears to the total amount of time or other measurement of use that was used for transmissions everywhere.

(iii) Outer-jurisdictional property shall be considered to have been used by the taxpayer in its business activities within Hawaii when that property, wherever located, is employed by the taxpayer in any manner in the publishing, sale, licensing, or other distribution of books, newspapers, magazines, or other printed material and any data, voice, image, or other information is transmitted to or from Hawaii either through an earth station or terrestrial facility located in Hawaii.

Example: One example of the use of outer-jurisdictional property is where the taxpayer either owns its own communications satellite or leases the use of uplinks, downlinks, circuits, or time on a communications satellite for the purpose of sending messages to its newspaper printing facilities or employees in a state. The state or states in which any printing facility that receives the satellite communications is located and the state from which the communications were sent, under this section, would apportion the cost of the owned or rented satellite to their respective property factors based upon the ratio of the in-state use of the satellite to its total usage everywhere.

Assume that ABC Newspaper Co. owns a total of $400,000,000 of property everywhere and that, in addition, it owns and operates a communication satellite for the purpose of sending news articles to its printing plant in Hawaii, as well as for communicating with its printing plants and facilities or news bureaus, employees, and agents located in other states and throughout the world. Also assume that the total value of its real and tangible personal property that was permanently located in Hawaii for the entire income year was valued at $3,000,000. Assume also that the total original cost of the satellite is $100,000,000 for the tax period and that of the 10,000 uplinks and downlinks of satellite transmissions used by the taxpayer during the tax period, 200 or 2 per cent are attributable to satellite communications received in and sent from Hawaii. Assume further that the company's mobile property has an original cost of $4,000,000 and was used in Hawaii for 95 days.

The property factor is determined as follows:

Value of property permanently in Hawaii:		$3,000,000
Value of mobile property (95/365 x $4,000,000):		1,041,096
Value of satellite property used in-state (.02 x $100,000,000):		2,000,000
Total value of property attributable to state:		$6,041,096
Property factor ($6,041,096/$500,000,000)	0.012082	

(2) The payroll factor shall be determined in accordance with sections 235-33 and 235-34, HRS, and the rules interpreting those sections.

(3) The following rules apply with respect to the sales factor.

(A) The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business,

except receipts that may be excluded under sections 18-235-35-01 to 18-235-36-02, section 18-235-38-03, or subparagraph (B).

(B) The numerator of the sales factor shall include all gross receipts of the taxpayer from sources within Hawaii, including, but not limited to, the following.

(i) Gross receipts derived from the sale of tangible personal property, including printed materials, delivered or shipped to a purchaser or a subscriber in Hawaii.

(ii) Except as provided in clause (c)(3)(B)(iii), gross receipts derived from advertising and the sale, rental, or other use of the taxpayer's customer lists or any portion of them shall be attributed to Hawaii as determined by the taxpayer's "circulation factor" during the tax period. The circulation factor shall be determined for each individual publication by the taxpayer of printed material containing advertising, and shall be equal to the ratio that the taxpayer's in-state circulation to purchasers and subscribers of its printed material bears to its total circulation to purchasers and subscribers everywhere.

The circulation factor for an individual publication shall be determined by reference to the rating statistics as reflected in such sources as Audit Bureau of Circulations or other comparable sources, provided that the source selected is consistently used from year to year for this purpose. If none of the foregoing sources are available, or, if available, none is in form or content sufficient for these purposes, then the circulation factor shall be determined from the taxpayer's books and records.

(iii) When specific items of advertisements can be shown, upon clear and convincing evidence, to have been distributed solely to a limited regional or local geographic area in which Hawaii is located, the taxpayer may petition, or the department may require, that a portion of such receipts be attributed to the sales factor numerator of Hawaii on the basis of a regional or local geographic area circulation factor and not upon the basis of the circulation factor as provided in clause (c)(3)(B)(ii). This attribution shall be based upon the ratio that the taxpayer's circulation to purchasers and subscribers located in Hawaii of the printed material containing specific items of advertising bears to its total circulation of the printed material to purchasers and subscribers located within that regional or local geographic area. This alternative attribution method shall be permitted only upon the condition that these receipts are not double counted or otherwise included in the numerator of any other state.

(iv) If the purchaser or subscriber is the United States Government or the taxpayer is not taxable in a State, the gross receipts from all sources, including the receipts from the sale of printed material, from advertising, and from the sale, rental, or other use of the taxpayer's customer lists, or any portion of them that would have been attributed by the circulation factor to the numerator of the sales factor for that State, shall be included in the numerator of the sales factor of Hawaii if the printed material or other property is shipped from an office, store, warehouse, factory, or other place of storage or business in Hawaii. [Eff 7/25/98] (Auth: HRS §§231-3(9), 235-38, 235-118) (Imp: HRS §235-38)

HRS §235-38.5 **§18-235-38.5-01 Construction.** In construing part II of chapter 235, HRS, the department shall be guided by the rules, regulations, and other published interpretations of the Multistate Tax Commission relating to the Uniform Division of Income for Tax Purposes Act and the Multistate Tax Compact, but with due regard to the water's edge requirement of section 235-38.5, HRS. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-38.5)

HRS §235-38.5 **§18-235-38.5-02 Exclusion of income, property, payroll, and sales of foreign affiliates.** (a) As used in this section:

"Foreign affiliate" of a taxpayer means a person, other than the taxpayer, if no part of the business income of the person is subject to the federal income tax under the federal Internal Revenue Code of 1986, as amended, whether or not the person and the taxpayer are owned or controlled directly or indirectly by the same interests.

"Subject to the federal income tax" when referring to a person means that the United States has jurisdiction to subject the person to the tax imposed by chapter 1 (with respect to income tax) of the federal Internal Revenue Code of 1986, as amended.

(b) The income of a taxpayer shall not be computed with reference to the income or other attributes (such as property, payroll, or sales) of a foreign affiliate.

(1) No taxpayer shall file, and the director shall not require a taxpayer to file, a combined report with a foreign affiliate.

(2) A taxpayer's business income subject to apportionment shall not include the business income, deductions, or losses of a foreign affiliate; provided that transactions between a taxpayer and a foreign affiliate, such as a dividend paid to a taxpayer by a foreign affiliate, shall be recognized and shall not be eliminated.

(3) For any taxpayer using the apportionment formula set forth in section 235-29, HRS, the numerator and the denominator of the taxpayer's property, payroll, and sales factors shall not include the property, payroll, or sales of a foreign affiliate.

(4) For any taxpayer using an apportionment formula other than that set forth in section 235-29, HRS, attributes of a foreign affiliate shall not be included in the taxpayer's apportionment computation.

(c) If the taxpayer and a foreign affiliate are engaged in a unitary business, the income of the taxpayer shall be segregated by allocation and separate accounting. The segregation shall be subject to adjustment under section 482 (with respect to allocation of income and deductions among taxpayers), IRC, and section 18-235-38-04.

(d) This section shall apply notwithstanding anything to the contrary in this subchapter. [Eff 11/25/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-38.5, IRC §482)

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SUBCHAPTER 3

INDIVIDUAL INCOME TAX LAW

HRS §235-51 **§18-235-51** (Reserved)

HRS §235-52 **§18-235-52** **Tax in case of joint return of spouses or the return of a surviving spouse.** (a) In the case of a joint return of a husband and wife under section 235-93, HRS, the tax imposed by section 235-51, HRS, shall be twice the tax which would be imposed if the taxable income were cut in half. This basis of determining the tax is reflected in the tax table provided under section 235-53, HRS, for a husband and wife filing a joint return or the return of a surviving spouse.

In computing the tax imposed by chapter 235, HRS, a husband and wife or a surviving spouse shall determine their tax as provided by sections 235-51 and 235-52, HRS, or, if applicable, as provided under section 235-53, HRS.

(b) Requirements for qualifying as a surviving spouse.

(1) If a taxpayer is eligible to file a joint return for the taxable year in which the taxpayer's spouse dies, the tax return of the taxpayer shall be treated as a joint return beginning with the year in which the spouse died and for the two consecutive taxable years thereafter; provided all three of the following requirements are satisfied:

(A) The taxpayer has not remarried before the close of the taxable year in which the return is sought to be treated as a joint return;

(B) The taxpayer maintains a household which constitutes the principal place of abode of a person who is a son or daughter (whether by blood or adoption), or stepdaughter or stepson of the taxpayer; and

(C) The taxpayer qualifies for the deduction for personal exemption under section 235-54(a), HRS (relating to deductions for dependents), with respect to the taxpayer's dependent son, stepson, daughter, or stepdaughter (whether by blood or adoption), or would have qualified for the deduction had the taxpayer not taken the exemption for blind, deaf, or person totally disabled, as provided by section 235-54(c), HRS, in lieu of the exemptions provided by section 235-54(a), HRS.

(2) Maintenance of household as home. For purposes of this subsection, maintenance of a household as a home shall be determined with respect to federal Treasury Regulations section 1.2-2(c)(1) and (d). [Eff 2/16/82; am 7/23/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-52)

HRS §235-53 **§18-235-53** **Tax tables for individuals.** (a) In general. In lieu of the tax imposed by section 235-51, HRS, the director of taxation shall set forth in tables the amount of tax based on the tax rates prescribed in section 235-51, HRS. As set forth in section 235-53, HRS, and this section, the tax shall be imposed on the taxable income of every individual who does not itemize deductions for the taxable year and whose taxable income does not exceed the ceiling amount, as defined in section 235-53(a)(2), HRS, for the taxable year.

(b) Taxpayers who itemize deductions. Pursuant to section 235-53, HRS, the director also may prescribe tax tables, based on the tax rates prescribed in section 235-51, HRS, for taxpayers who itemize their deductions.

(c) Short taxable periods; estates and trusts. Section 235-53, HRS, and this section shall not apply to trusts, estates, or individuals making a return for a short taxable period of less than twelve months due to a change in the taxpayer's accounting period. [Eff 2/16/82; am 7/23/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-53)

HRS §235-54 **§18-235-54** **Exemptions.** (a) Individual. In computing taxable income, individual taxpayers are allowed a deduction for the exemptions as provided in section 235-54, HRS. For taxable years after December 31, 1984, this deduction is determined as follows:

(1) Ascertain the number of exemptions which the individual can lawfully claim under section 151, IRC, (allowance of deductions for personal exemptions);

(2) Add an additional exemption if the taxpayer or the taxpayer's spouse is sixty-five years of age or older within the taxable year; and

(3) Multiply by $1,040.

The exemption for a taxpayer or a taxpayer's spouse who is blind, deaf, or totally disabled shall be as set forth in section 235-54(c), HRS, and subsection (c).

(b) Estate or trust. In computing taxable income, an estate or trust is allowed a deduction for the exemptions as provided in section 235-54(b), HRS, as follows:

(1) An estate is allowed a deduction of $400;

(2) A trust which is required to distribute all of its income for the taxable year, pursuant to the terms of the trust instrument, is allowed a deduction of $200; and

(3) All other trusts are allowed a deduction of $80.

A trust which is required to distribute all of its income currently is allowed a deduction of $200, even though it also distributes amounts other than income in the taxable year and even though it may be required to make charitable contributions and, therefore, does not qualify as a simple trust under sections 651 and 652, IRC (trusts which distribute current income only). A trust for the payment of an annuity is allowed a deduction of $200 in a taxable year in which the amount of the annuity required to be paid equals or exceeds all the income of the trust for the taxable year.

(c) Blind, deaf, or totally disabled person. In lieu of the exemptions provided by section 235-54, HRS, and subsection (a), a blind, deaf, or totally disabled person is allowed an exemption of $7,000 in computing taxable income.

(1) Definition. For purposes of section 235-54, HRS, and this section, the terms "blind", "deaf", and "person totally disabled" shall be defined as set forth in section 235-1, HRS.

(2) Burden of proof. A taxpayer who qualifies as blind, deaf, or totally disabled, pursuant to section 235-1, HRS, is entitled to claim the special exemption available under section 235-54, HRS, and this section. To claim the special exemption, the taxpayer shall provide the department with sufficient proof of the disability as required under section 235-1, HRS. If the taxpayer does not provide sufficient evidence of the disability as required in section 235-1, HRS, the taxpayer may not claim the special exemption. The blind, deaf, or totally disabled taxpayer also may elect not to claim the special exemption.

(3) Status determination date; reexamination. Qualification for the special exemption shall be determined as set forth in this subsection. The date establishing the determination of blindness, deafness, or total disability for these purposes shall be referred to as the "status determination date". A blind, deaf, or person totally disabled shall be reexamined, as directed by the department, in order to maintain the blind, deaf, or totally disabled status and to continue to qualify for the special exemption.

(4) Single taxpayer. In the case of a single person filing an individual tax return, blindness, deafness, or total disability is determined as of the close of the taxpayer's taxable year. If the taxpayer qualifies as blind, deaf, or person totally disabled as set forth in this subsection, the taxpayer is entitled to take the special exemption of $7,000 as set forth in section 235-54(c), HRS.

(5) Joint return of husband and wife. In the case of a joint return of a husband and wife, blindness, deafness, or total disability is determined as of the close of the taxable year of the spouse who qualifies for the special exemption. If both spouses qualify for the special exemption, they may take up to a total combined exemption of $14,000 for the taxable year. If only one spouse qualifies for the special exemption, the total combined exemption for the taxable year of both spouses shall be calculated by adding together the following:

(A) For the spouse who qualifies as a blind, deaf, or person totally disabled, an exemption of $7,000; and

(B) For the spouse who does not qualify as a blind, deaf, or person totally disabled, an exemption of $1,040 multiplied by 1 (if this spouse had not attained the age of sixty-five before the close of the taxable year), or $1,040 multiplied by 2 (if this spouse was at least sixty-five years old before the close of the taxable year).

No additional exemptions shall be taken for dependents; the special exemption is available in lieu of any personal exemptions to which the taxpayer may be entitled.

(6) Married person, filing separately; person qualifying for the special exemption. A married person filing separately who qualifies as blind, deaf, or totally disabled, by the close of the person's taxable year is entitled to an exemption of $7,000; person not qualifying for the special exemption. In the case of a married person filing separately who does not qualify for the special exemption, but whose spouse is a blind, deaf, or person totally disabled, the amount of exemption allowed for the taxable year shall be determined as follows: $1,040 multiplied by the number of exemptions which the nonqualifying taxpayer may lawfully claim under section 151, IRC, (allowance of deductions for personal exemptions), for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. The taxpayer, however, shall not take additional exemptions with regard to the taxpayer's spouse's blindness, deafness, or total disability.

(d) Short period, annualized income. If a taxpayer's income is annualized to determine tax liability for a short period, as provided in section 443(b)(1), IRC, (returns for a period of less than 12 months), the personal exemptions set forth in section 235-54, HRS, and this section, shall be reduced to an amount which is proportionate to

the number of months in the short period as compared to twelve. Computing the proportionate exemption amount for a short period, resulting from conversion to or from a fifty-two to fifty-three week taxable year, shall be made as allowed by the director.

If, however, a taxpayer's income is annualized to determine tax liability for a short period due to a change in the taxpayer's residency, the taxpayer may claim the entire personal exemption amount which the taxpayer is entitled to claim. [Eff 2/16/82; am 7/23/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-54)

HRS §235-55 **§18-235-55 Tax credits for resident taxpayers.** (a) For purposes of this section:

"Foreign jurisdiction" means any state, territory, or possession of the United States, or any foreign country, except Hawaii. State, territory, or possession of the United States includes the District of Columbia and Puerto Rico.

"Resident" as used in this section is defined by section 235-1, HRS.

(b) In general. To receive credit under section 235-55, HRS, part or all of a taxpayer's taxable income for the taxable year must have been derived or received from sources outside the State and taxed by a foreign jurisdiction, as illustrated by the following examples:

Example 1: Taxpayer, a resident of Hawaii, is a beneficiary of a trust. The trustee of the trust is a trust company organized and doing business in State X, where the trust corpus is held and administered. Trust income received by the taxpayer includes interest derived from Hawaii State bonds and State X bonds. Under chapter 235, HRS, all income received by a Hawaii resident, regardless of source, is subject to Hawaii income tax. Therefore, all interest received by the taxpayer from the trust shall be subject to Hawaii income tax. In the event State X also imposes a tax on the entire income received by the taxpayer from the trust, including interest from State X bonds, the taxpayer may claim tax credit under section 235-55, HRS, and this section for the portion of the tax which is attributable to the interest income derived from the State X bonds. The tax credit available under section 235-55, HRS, will prevent the interest income from being taxed by both Hawaii and State X.

Example 2: Taxpayer, a resident of Hawaii, earns a salary in Hawaii and owns rental property located in State Y. The rental property is the taxpayer's only source of income from State Y. In 1993, after subtracting allowable deductions related to the rental property from the total gross rental income, the taxpayer sustains a loss from the rental property for State Y tax purposes.

As set forth in section 235-4, HRS, all income received by a Hawaii resident, regardless of source, is subject to Hawaii income tax. If State Y also considers the taxpayer a resident, and imposes State Y income tax on the taxpayer's taxable income, Hawaii income tax credit may be available. In this particular case, however, the taxpayer may not take any Hawaii income tax credit on account of any State Y tax will report a loss for State Y tax purposes. Under section 235-55, HRS, and this section, income tax credit only is available if all or a part of a taxpayer's income is derived or received from sources outside the State and taxed by a foreign jurisdiction. Therefore, for purposes of this section, no Hawaii income tax credit is available.

Example 3: Taxpayer, a resident of Hawaii, owns rental property in State M and carries on a business in Hawaii. Taxpayer receives income from both the rental property and the business during the taxable year; taxpayer has no other income.

Taxpayer's net income from the rental property is $10,000 and the Hawaii business shows a net operating loss of $6,000. As a result, taxpayer's Hawaii net adjusted gross income is $4,000. If State M also imposes a tax on the income from the rental property, the taxpayer may claim Hawaii income tax credit under section 235-55, HRS, and this section. The amount of tax credit available shall be equal to the amount of State M tax paid by the taxpayer on the rental property income.

(c) Taxpayer eligible for the credit. Only an individual resident taxpayer, or an estate or trust liable for taxes imposed upon an individual, may claim tax credit under section 235-55, HRS and this section.

Tax credit under section 235-55, HRS, and this section, however, is not available for taxpayers described in section 3 of Act 60, SLH 1976: namely those taxpayers who have taken up residence in the State (1) after attaining the age of sixty-five years, and (2) before July 1, 1976. For these taxpayers, income from sources outside the State are not includable in their taxable income for Hawaii income tax purposes. Since tax credit only is available for tax paid on income taxed by a foreign jurisdiction and which is includable in taxable income for Hawaii income tax purposes, these taxpayers do not qualify for tax credit under section 235-55, HRS, and this section.

(d) Taxes which qualify for the credit.

(1) Taxes paid to a foreign jurisdiction qualify for Hawaii income tax credit under section 235-55, HRS, and this section, if the taxpayer can show that:

(A) The taxpayer is liable for and has paid tax to the foreign jurisdiction. Nothing contained in section 235-55, HRS, or this section shall be construed to permit a credit against the taxes imposed by chapter 235, HRS, on account of federal income taxes paid.

(B) The tax paid to the foreign jurisdiction is an income-based tax. Tax imposed with respect to a privilege, activity, occupation, trade, business, or calling is not an income-based tax. In addition, no income tax credit may be claimed for any interest or penalties paid in connection with any income tax imposed by the foreign jurisdiction.

(C) The tax paid to the foreign jurisdiction is based upon net income, and that the income is taxed in the same taxable year in which the tax credit is claimed. Taxes imposed on a taxpayer's gross receipts or gross income, which must be paid regardless of whether or not the gross receipts or gross income constitutes net income, do not qualify for tax credit under section 235-55, HRS, and this section. These taxes do not qualify for tax credit, even though in particular instances the income which is taxed is net income in whole or in part.

Taxes imposed upon wages and salaries for services performed within a foreign taxing jurisdiction may qualify for tax credit; the tax must be imposed as a part of a net income tax, even though no deductions are allowed in respect of wages and salaries.

(D) The tax is equally applicable to residents and nonresidents. Tax credit may only be taken if the tax imposed by the foreign jurisdiction applies to the taxpayer's income irrespective of the taxpayer's residence status. For example, Canada imposes a fifteen per cent withholding tax on gross dividends paid by a Canadian company to a nonresident taxpayer does not qualify for tax credit. This Canadian tax liability shall not qualify for a tax credit pursuant to section 235-55, HRS, and this section, because the tax is not equally imposed on both residents and nonresidents.

(2) Income taxes imposed by another jurisdiction shall not qualify for tax credit unless it can be established that the source of the income is outside Hawaii. Taxes paid under the following circumstances, even if imposed as part of a net income tax, shall not qualify for tax credit:

(A) Taxes imposed by a foreign jurisdiction upon dividends and interest, merely because the distributing corporation is a domestic corporation or is a foreign corporation resident in the foreign jurisdiction;

(B) The earnings and profits from which the dividends are paid are generated from business carried on in the foreign jurisdiction; or

(C) The debtor paying the interest is a resident of the foreign jurisdiction.

(e) Calculating the net amount of tax paid to a foreign jurisdiction.

(1) The amount of tax credit which a taxpayer may claim under section 235-55, HRS, and this section is the net amount of tax paid to a foreign jurisdiction after all credits, reductions, and refunds allowed or allowable by the laws of the foreign jurisdiction have been deducted. The amount of credit available under section 235-55, HRS, and this section, shall not exceed the amount of tax for which the taxpayer is liable to the foreign jurisdiction. A taxpayer must take any credit, reduction, or refund available to the taxpayer to offset the tax liability incurred under the foreign jurisdiction's tax laws.

(2) All deductions shall be taken when determining the tax liability under the foreign jurisdiction's tax laws even if the taxpayer chooses not to take the deductions at the time the return is filed, including any credit allowed for Hawaii income tax paid under chapter 235, HRS.

However, if the taxpayer does not pay the Hawaii income tax prior to or at the time the foreign jurisdiction income tax return is filed, the laws of the foreign jurisdiction usually will not allow the taxpayer to claim any tax credit for the Hawaii tax at that time.

(3) Unless otherwise provided under section 235-55, HRS, and this section, tax credit for tax paid to a foreign jurisdiction may not be claimed until after the tax is paid to the foreign jurisdiction. If, after paying the Hawaii income tax, the taxpayer obtains a credit or refund of tax paid to the foreign jurisdiction, the credit or refund must be reported as provided in this section.

(f) Calculating the amount of foreign jurisdiction tax eligible for tax credit. As set forth in this section, only tax on income derived or received from sources outside the State and taxed by another jurisdiction is eligible for tax credit. Tax paid to a foreign jurisdiction on income from a source in the State or income which is excluded from Hawaii income tax is not eligible for tax credit under section 235-55, HRS, and this section. In calculating a taxpayer's

foreign jurisdiction tax liability, only deductions related to the income or property subject to the tax of the foreign jurisdiction shall be allowed.

The amount of tax credit which the taxpayer may claim shall be limited to the lesser of: the maximum amount of credit allowed as calculated under this subsection; or the actual amount of tax, which qualifies for the tax credit, paid to the foreign jurisdiction. To determine the maximum amount of credit allowed under section 235-55, HRS, the taxpayer shall:

(1) Calculate the amount of the taxpayer's Hawaii income tax liability, for the taxable year, based on the taxpayer's entire income without regard to source;
(2) Calculate the amount of the taxpayer's Hawaii income tax liability, for the taxable year, based on the taxpayer's entire income less any income which also is taxed by the foreign jurisdiction;
(3) Subtract the amount of tax liability calculated in paragraph (2) from the amount of tax liability calculated in paragraph (1).

The difference is the maximum amount of credit which is allowed under section 235-55, HRS. The maximum amount of credit allowed, however, shall be compared to the actual amount of tax paid to the foreign jurisdiction; the lesser of the two shall be the amount which the taxpayer may claim as tax credit pursuant to 235-55, HRS, and this section.

Example 1: A married resident of Hawaii has taxable income of $14,000 in 1993; $9,000 is from a source in Hawaii and $5,000 is from a source in State Q. Both Hawaii and State Q require the taxpayer to report the $5,000 as income.

The taxpayer files a joint Hawaii income tax return for 1993; the taxpayer's spouse reports no income. After taking the standard deduction, but before any tax credit is taken, taxpayer's Hawaii income tax liability based on taxable income of $14,000 is $792 (calculated using the tax tables prescribed by the director under section 235-53, HRS). Had the Hawaii income tax been computed based only on the $9,000 from sources in Hawaii, the tax would have been $407. For purposes of this rule, State Q income tax for 1993, imposed upon the taxpayer as a nonresident with respect to the income having its source in State Q, is $129. The computation of the credit is as follows:

Hawaii income tax on entire income	$792
Hawaii income tax on income from sources in Hawaii	407
Maximum credit allowable	$385
($792 minus $407)	

Since the actual amount of State Q tax paid ($129) is less than the $385 maximum credit allowable, the actual amount of Hawaii income tax credit which may be taken is $129. Unless there are any further reductions (e.g., reductions for any tax credit granted by State Q for any Hawaii income tax paid), the amount of tax credit available shall remain $129.

Example 2: An individual taxpayer, whose domicile is in Hawaii, temporarily resides in State X. The taxpayer earns a salary of $10,000 for personal services performed in State X. Taxpayer also has rental income of $5,000 from real property located in Hawaii and $2,000 in distributions from a partnership located in and doing business in Hawaii.

Under the provisions of State X law, the taxpayer's salary ($10,000) and partnership income ($2,000) but not the rental income, are subject to income tax. In this case, State X income tax on $12,000 of taxable income is $226. After applying all available State X tax credits, the taxpayer can reduce the State X tax liability to $162.

For purposes of this example, assume the taxpayer elects to take the standard deduction and that the State X tax is paid before the Hawaii income tax liability is paid. The taxpayer's Hawaii income tax liability based on taxable income of $17,000 (using the tax tables prescribed by the director under section 235-53, HRS) is $1,023. The tax liability on income only from sources in Hawaii is $69. The amount of Hawaii income tax credit available to the taxpayer, therefore, shall be the lesser of the maximum amount of credit allowable, or the actual amount of tax paid to the foreign jurisdiction:

Hawaii income tax on entire income	$1,023
Hawaii income tax from sources in Hawaii	69
Maximum credit allowable	$ 954
($1,023 - 69 = $954)	

Compare the maximum amount of credit allowable ($954) with the amount of tax actually paid to the foreign jurisdiction ($162). The maximum amount of tax credit the taxpayer may claim is the lesser of the two amounts ($162). The amount of tax credit shall not be reduced any further, because when the taxpayer filed the State X tax return, the taxpayer claimed all available credits.

(g) No credit against penalties or interest. Tax credit under section 235-55, HRS, and this section, may not be applied against penalties or interest due under section 231-39 and section 235-97, HRS, or any other provision.

(h) How to claim the credit.

(1) In general, credit for taxes paid to a foreign jurisdiction under section 235-55, HRS, and this section, may be claimed either subsequent to or at the time the Hawaii income tax return is filed for the taxable year as set forth in section 235-97(b), HRS. Credit also may be claimed for the payment of a deficiency assessment to a foreign jurisdiction. Taxpayers, however, shall not receive credit for any amount attributable to penalties and interest paid to a foreign jurisdiction.

Except as provided in this subsection, credit may not be claimed unless, at the time the Hawaii income tax return is filed, the tax has already been paid to the foreign jurisdiction. The credit amount claimed on the Hawaii income tax return, subject to the limitations provided by section 235-55, HRS, and this section, shall be the lesser of the maximum credit allowed or the amount the taxpayer actually paid to the foreign jurisdiction for the same taxable year. The tax credit under section 235-55, HRS, and this section, for any tax paid to a foreign jurisdiction shall not be claimed for any taxable year except that taxable year for which the return is filed with the foreign jurisdiction.

(2) If a taxpayer qualifies for and claims a tax credit under section 235-55, HRS, and this section, a copy of the tax return filed with the foreign jurisdiction must be attached to the taxpayer's Hawaii income tax return. If the taxpayer is claiming a tax credit for the payment of a deficiency assessment, the taxpayer shall attach a copy of the notice assessing or proposing to assess the deficiency.

The taxpayer shall make available, upon request by the director or designee, records substantiating the payment of tax to the foreign jurisdiction. Records substantiating payment of tax to the foreign jurisdiction include a certified copy of the tax return, receipt of payment, or a canceled check.

(3) If either the taxpayer's Hawaii income tax liability for the taxable year is paid before the tax credit is claimed, or the taxpayer wishes to file the Hawaii income tax return before the foreign jurisdiction's return is filed, the taxpayer may claim the tax credit by amending the taxpayer's Hawaii income tax return after the foreign jurisdiction tax actually has been paid. Upon determination that the taxpayer qualifies for the credit, the appropriate amount shall be credited or refunded to the taxpayer as provided under section 235-110, HRS.

(4) Upon approval of the director or designee, a taxpayer also may choose to present a tentative claim for tax credit provided under this section on the Hawaii income tax return before the tax has been paid to the foreign jurisdiction. The Hawaii income tax return shall be accompanied by payment of the amount of Hawaii income tax due on the return, less the tentative credit amount. Once a tax return is filed with the foreign jurisdiction, a copy of the foreign jurisdiction tax return must be submitted to the department with a copy of the Hawaii income tax return on which the tax credit is claimed; the copy of the foreign tax return shall be filed with the Department within thirty days after the tax return is filed with the foreign jurisdiction. If necessary, the taxpayer also shall amend the Hawaii income tax return to reflect any difference in the amount of tentative credit claimed and the amount of tax actually paid to the foreign jurisdiction.

Tax credit available under this section may be disallowed if: a taxpayer fails to submit a copy of the foreign jurisdiction tax return within thirty days of its filing with the foreign jurisdiction; or if the taxpayer fails to file a tax return with the foreign jurisdiction. In both instances, the taxpayer shall amend the Hawaii income tax return to reflect the disallowance of the credit and pay the appropriate Hawaii income tax. Penalties and interest as set forth in section 231-39, HRS, may be applicable.

(i) Duty to report reduction in tax of the foreign jurisdiction. If a taxpayer has obtained or at any time obtains, a credit for, or a refund of, taxes paid to a foreign jurisdiction and for which tax credit under section 235-55, HRS, and this section is or has been claimed, or claimed and allowed, the entire amount of the credit or refund must be reported by the taxpayer. The taxpayer shall report the credit or refund at the time the claim for tax credit is made

under section 235-55, HRS, or if the claim for tax credit already has been made, within twenty days after the taxpayer is notified of the credit or refund. Failure to report the credit or refund within the required period is deemed a failure to file a return and is subject to penalties and interest as provided by sections 231-39 and 235-55(b), HRS.

Any credit or refund reporting requirement under this subsection shall be made in the form of an amendment to the taxpayer's Hawaii income tax return. The taxpayer shall amend the taxpayer's Hawaii income tax return for the taxable year in which the tax credit is taken.

(j) Husband and wife. If a husband and wife file separate returns under chapter 235, HRS, and also file separate returns in the foreign jurisdiction, credit for taxes paid to the foreign jurisdiction may be claimed by each spouse only to the extent that the income of the spouse, as reported under chapter 235, HRS, has been taxed by the foreign jurisdiction. If a husband and wife file a joint return under chapter 235, HRS, the entire amount of taxes paid by either or both to the foreign jurisdiction may be claimed as a credit, regardless of whether the husband and wife filed a joint return or separate returns in the foreign jurisdiction. If a husband and wife file separate returns under chapter 235, HRS, but file a joint return in the foreign jurisdiction, each spouse may claim credit for their proportionate share of the tax paid to the foreign jurisdiction on the joint return. The ratio shall be determined by calculating the income of each spouse, taxed under chapter 235, HRS, and also taxed by the foreign jurisdiction, as it bears to the income taxed by the foreign jurisdiction on the joint return. [Eff 2/16/82; am 7/23/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-55)

HRS §235-55.5 **§18-235-55.5** Repealed. [R 7/23/94]

HRS §235-55.6 **§18-235-55.6** (Reserved)

HRS §235-55.7 **§18-235-55.7** **Income tax credit for low-income household renters.** (a) In general. Section 235-55.7, HRS, provides an income tax credit for low-income household renters.

As used in this section:

"Adjusted gross income" shall be defined as set forth in section 235-1, HRS.

"Dependent" shall be defined pursuant to section 152, IRC, (dependent defined).

"Principal residence" means the dwelling place that constitutes the principal place of abode of the taxpayer or the taxpayer's immediate family in this State, as opposed to a dwelling which is used for vacation, educational, or other temporary purposes.

"Qualified exemption" means an exemption which is allowed under section 235-54, HRS. Persons for whom an exemption is claimed must have physically resided in the State for more than nine months during the taxable year. There are no exceptions to this provision. Thus, a person who is out of the State for a period of three months or more, for any reason (including attending school or business), shall not qualify for an exemption.

"Rent" means the amount paid in cash for the taxable year for the occupancy of a dwelling place which is not partially or wholly exempted from real property tax. Rent shall not include any amounts claimed as a deduction from gross or adjusted gross income for income tax purposes, or any amount received as a rental allowance or subsidy from any source. For purposes of claiming this credit, rent means the money paid for use of the dwelling only and does not include ground rent, utilities, goods, services, and the like.

"Resident taxpayer" shall be defined as an individual whose entire income is subject to tax under chapter 235, HRS, as imposed by section 235-4, HRS, without regard to source.

(b) Amount of tax credit. Each taxpayer with an adjusted gross income of less than $30,000, who has paid more than $1,000 in rent during the taxable year for which the credit is claimed, may claim a tax credit under section 235-55.7, HRS. The amount of tax credit available is calculated by multiplying $50 by the number of qualified exemptions the taxpayer is entitled; provided that a resident individual who has no income or taxable income under chapter 235, HRS, also may claim the tax credit. If a taxpayer or spouse is age sixty-five or older, the taxpayer may claim double the tax credit; however, no additional exemptions shall be granted for blindness, deafness, or total disability.

(c) Taxpayer may not be a dependent of another taxpayer. Even though a taxpayer is a resident of the State and is required to file a resident income tax return, the tax credit under section 235-55.7, HRS, may not be claimed if the taxpayer qualifies as a dependent of another taxpayer under federal or state laws and rules, even if the taxpayer entitled to claim the dependency exemption does not take it. A dependent is defined in section 152, IRC, (dependent defined), and is illustrated by the following example.

> **Example:** Jane Doe, a full-time student, works part time and earned $1,500 during the taxable year. Jane is required to file a Hawaii resident income tax return. Her father furnished over fifty per cent of her support. Although Jane's father is entitled to claim her as a dependent on both his federal and state income tax returns, he elects not to claim Jane as a dependent on his state income tax return. Jane may not claim the tax credit under section 235-55.7, HRS, since she may be claimed as a dependent by her father.

(d) Maintenance of records. Taxpayers claiming this credit shall maintain properly dated rent receipts. The receipts shall state the name of the taxpayer, the address of the dwelling for which the rent is paid, and the amount of rent paid, to substantiate the claim for the tax credit. Claims for the tax credit shall be made on forms approved by the department and are subject to section 231-34, HRS. [Eff 2/16/82; am 7/23/94] (Auth: HRS §§231-3(9), 235-55.7, 235-118) (Imp: HRS §235-55.7)

HRS §235-55.8 **§18-235-55.8 Food/excise tax credit.** (a) For purposes of section 235-55.8, HRS, and this section:

"Resident taxpayer" means an individual whose entire income is subject to income tax under chapter 235, HRS, and as imposed by section 235-4, HRS, without regard to source.

"Qualified exemption" means an exemption which is allowed under section 235-54, HRS, except as otherwise provided in this section. Additional exemptions available for blindness, deafness, or total disability under section 235-54, HRS, shall not qualify as an exemption for purposes of section 235-55.8, HRS, and this section. In addition, for purposes of section 235-55.8, HRS, and this section, a parent or guardian may claim an exemption for a dependent minor child receiving support from the department of human services of the State, social security survivor's benefits, and the like.

(b) In general.

(1) Taxpayers eligible to claim food/excise tax credit. Pursuant to section 235-55.8, HRS, and this section and except as provided in this section, every resident taxpayer whether or not required to file an individual income tax return for a taxable year may claim the food/excise tax credit.

(2) Exceptions. Pursuant to section 235-55.8, HRS, tax credit shall not be available to:

(A) A resident taxpayer who is eligible to be claimed as a dependent by another taxpayer for federal or state income tax purposes. While a dependent resident taxpayer may be required to file income tax return, the dependent resident taxpayer is not eligible to claim the food/excise tax credit if the dependent resident taxpayer qualifies as a dependent of another taxpayer under federal or state statutes and rules, as defined in section 152, IRC (dependent defined). The dependent resident taxpayer may not claim the tax credit even if the taxpayer eligible to claim the credit for the dependent does not take it.

(B) Any individual who has not physically resided in the State for more than nine months during the taxable year. No exemptions shall be available for individuals who are out of the State for business, vacation, education, or other reasons for more than three months in total during the taxable year.

(C) Any individual who has been convicted of a felony, has been committed to prison, and has been physically confined in a prison for the full taxable year.

(D) Any individual who would otherwise be eligible to be claimed as a dependent but has been committed to a youth correctional facility and has resided at the facility for the full taxable year.

(E) Any misdemeanant who has been committed to jail and has been physically confined for the full taxable year.

Example: Jane Doe, a full-time student, works part-time and earned $1,500 during the taxable year. Jane is required to file a Hawaii income tax return. Her father furnished over fifty per cent of her support and is entitled to claim her as a dependent on his federal income tax return. However, he elects not to claim Jane's dependency exemption on his state income tax return. Jane may not claim the food/excise tax credit since she may be claimed as a dependent on her father's federal tax return.

(c) Calculating the amount of tax credit. The total amount of tax credit available shall be calculated by multiplying the number of qualified exemptions the taxpayer is entitled to take by the sum of:

(1) $55, and

(2) The amount of credit available to the resident taxpayer based on the resident taxpayer's adjusted gross income as set forth in section 235-55.8(b)(2), HRS, which shall be doubled for each resident taxpayer age sixty-five or older.

If married resident taxpayers file separately, the amount of credit available shall be based on the combined adjusted gross income of the spouses.

(d) Application of credits. Credits claimed under section 235-55.8, HRS, shall be deductible from the resident taxpayer's income tax liability, if any, for the taxable year in which the credits are claimed. If the credits exceed the resident taxpayer's tax liability for the taxable year, the excess shall be refunded to the resident taxpayer;

provided the resident taxpayer has no tax liability due to the department. No refunds or payment on account of tax credits available under section 235-55.8, HRS, shall be made for an amount less than $1.

(e) All claims for tax credit under section 235-55.8, HRS, shall be made on or before the end of the twelfth month following the taxable year for which the credits were claimed. Failure to comply with the foregoing provision shall constitute a waiver of the right to claim the credit. [Eff 7/23/94] (Auth: HRS §235-55.8) (Imp: HRS §235-55.8)

Historical note: §18-235-55.8 substantially incorporates §18-235-55.5. [Eff 2/16/82; R 7/23/94]

HRS §235-61 **§18-235-61** Amended and renumbered §18-235-61-01 to §18-235-61-14. [10/13/94]

HRS §235-61 **§18-235-61-01 Deduction and withholding of income tax; in general.** Section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14 relate to the deduction and withholding of income tax from remuneration paid for or attributable to services of an employee. These rules supplement sections 235-61 to 235-67, HRS. [Eff 2/16/82; am and ren §18-235-61-01 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61(e) **§18-235-61-02 Definitions.** For purposes of section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14:

"Employee" shall be defined as set forth in section 235-61(a), HRS.

"Employer" shall be defined as set forth in section 235-61(a), HRS, and includes an individual who is self-employed during the taxable year.

"Miscellaneous payroll period" means a payroll period other than a daily, weekly, biweekly (or other multiple of a week), semimonthly, monthly, quarterly, semiannual, or annual payroll period. The payroll period is to be used in determining the amount of tax to be withheld, except as otherwise provided in section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14.

"Payroll period" means the period of service for which a payment of wages is ordinarily made by an employer to an employee. The payroll period is to be used in determining the amount of tax to be withheld, except as otherwise provided in section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14.

"Remuneration" includes all payments, whether in cash or in a medium other than cash, for services rendered in the course of the employer's trade or business.

"Resident" shall be defined as set forth in section 235-1, HRS.

"Wages" shall be defined as set forth in section 235-61(a), HRS. [Eff 2/16/82; am and ren §18-235-61-02 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

§18-235-61-03 Wages subject to withholding. (a) An employer shall deduct and withhold tax from wages paid to an employee for services rendered, unless otherwise provided in section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14. Wages earned by a self-employed individual, however, are not subject to withholding under section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14. An exemption from withholding does not automatically exempt income from income taxation.

(b) Exceptions.

(1) An employer shall not withhold tax from income which is excluded from gross income pursuant to sections 235-2.3 and 235-7, HRS. For example, an employer shall not withhold tax from:

(A) The rights, benefits, and other income, received under the state retirement system, exempted pursuant to section 88-91, HRS, or any comparable rights, benefits, and other income received under any other public retirement system.

(B) Any compensation received in the form of a pension for past services rendered.

(C) Remuneration paid to a patient affected with Hansen's disease, employed by the State, in any hospital, settlement, or place for the treatment of Hansen's disease.

(D) The first $1,750 received by each member of the reserve components of the Army, Navy, Air Force, Marine Corps, or Coast Guard of the United States of America, and the Hawaii national guard as compensation for performance of duty. Compensation in excess of $1,750 shall be subject to withholding and shall be reported on the income tax return of the recipient.

With respect to payments which are excluded from income pursuant to section 235-7(a)(1), (5), and (6), HRS, the employer shall withhold tax from the payments to the employee unless the employer or employee presents evidence regarding the exclusion and obtains a ruling from the department exempting the income from the withholding requirements of section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14.

(2) Additionally, the director finds withholding from the following payments to be unduly onerous or impracticable of enforcement. Therefore, an employer shall not withhold tax from the following payments:

(A) Compensation paid as a weekly benefit for unemployment up to but not in excess of the amount provided by the federal Employment Security Law. Limitations applicable to payments from federal or state treasury funds or accounts shall apply to payments by an employer, trust, or other means provided by an employer. Although not subject to withholding, unemployment benefits shall be reported on the income tax return of the recipient.

(B) Payments to or on behalf of an employee or the employee's beneficiary, or from or to a trust created pursuant to section 401, IRC, (qualified pension, profit-sharing, and stock bonus plans), except where the payment is made to an employee of the trust as remuneration for services rendered as an employee and not as a beneficiary of the trust. Additionally, payments to or on behalf of an employee or the employee's beneficiary, under or to an annuity plan as described in section 403(a), IRC, shall not be subject to withholding. Although not subject to withholding, payments subject to this paragraph shall be reported on the income tax return of the recipient.

(C) The fair market value of meals and lodging furnished to an employee, provided, the lodging is required as a condition of employment. Although not subject to withholding, the fair market value of meals and lodging subject to this paragraph shall be reported on the income tax return of the recipient.

(D) Wages paid to the estate or beneficiary of a deceased employee, who dies before the date for payment of wages. Wage payments, however, are includable in the income tax return of the estate or beneficiary who acquires the right to receive the wage payments due to the employee's death, unless the payments are wages includable in the income tax return of the decedent.

(E) Amounts paid to a person who is blind, deaf, or totally disabled, whose disability has been certified to as set forth in section 235-1, HRS. This paragraph applies to the first payroll period ending, or first payment of wages made without regard to a payroll period, on or after the date the certificate is presented to the employer. Thereafter, the exemption applies to all payroll periods and payments unless re-examination shows that the taxpayer no longer qualifies as a person who is blind, deaf, or totally disabled. If the taxpayer no longer qualifies for the exclusion under this paragraph, the existing certificate allowing for the exclusion from withholding shall be treated in the following manner:

(i) If the date of the re-examination is after June 30 and before January 1, withholding is not required for the entire calendar year in which the re-examination occurred; or

(ii) If the date of the re-examination is between January 1 but before July 1, withholding is required as of July 1.

Although withholding is not required upon the wages of a person who is blind, deaf, or totally disabled, if the conditions set forth in this paragraph are met, the employer must provide the employee and the director or designee a Form HW-2 showing the total wages and other required information.

The employer shall report the information in the same manner as in the case of an employee whose withholding exemptions exceed the amount of wages subject to withholding. Additionally, the wages of a person who is blind, deaf, or totally disabled must be included on Forms HW-14 and HW-3 filed by the employer. Although not subject to withholding, payments subject to this paragraph shall be reported on the income tax return of the recipient.

(F) Fees paid by persons other than the government or a government agency, and to public officials for the performance of their duties (such as fees paid to notaries and sheriffs). Although not subject to withholding, fees subject to this paragraph shall be reported on the income tax return of the recipient.

(G) Per diem amounts, mileage reimbursements, or fees paid to jurors and witnesses, or to public officials providing a temporary and nonrecurring service or who serve not more than once a year (i.e., election officials). Although not subject to withholding, fees subject to this paragraph shall be reported on the income tax return of the recipient.

(H) Remuneration for services performed by an individual under the age of eighteen in the delivery or distribution of newspapers or shopping news, excluding delivery or

distribution to a place for subsequent delivery or distribution. Although not subject to withholding, remuneration subject to this paragraph shall be reported on the income tax return of the recipient.

(I) Remuneration for services performed by an individual in and at the time of the sale of newspapers or magazines to consumers, where compensation is based on the retention of the balance of the fixed price at which the newspapers are sold less the cost of the newspapers or magazines to the individual (whether or not the individual is guaranteed a minimum amount of compensation or is credited for any unsold newspapers or magazines returned). Although not subject to withholding, remuneration subject to this paragraph shall be reported on the income tax return of the recipient.

(J) Tips or gratuities in any medium other than cash, or cash tips of less than $20 in any calendar month, received by an employee in the course of employment by an employer. If an employee receives tips or gratuities of $20 or more in any calendar month and the employee is required to furnish the employer a statement of tips or gratuities received under section 6053 of the IRC (with respect to reporting of tips), withholding shall be required. Whether or not withholding is required on tips or gratuities under this paragraph, all tips or gratuities shall be reported on the income tax return of the recipient.

(K) Cash remuneration for casual services not in the course of an employer's trade or business, including domestic services, of less than $50 per calendar quarter.

If an individual, who is regularly employed by an employer, also performs casual services not in the course of trade or business and is paid $50 or more per calendar quarter for the services, then the remuneration shall be subject to withholding. Whether or not subject to withholding, remuneration subject to this paragraph shall be reported on the income tax return of the recipient.

For purposes of this paragraph, an individual shall be deemed to be regularly employed by an employer during a calendar quarter only if:

(i) On each of some twenty-four days during the quarter, the employee performs services for the employer which are not in the course of the employer's trade or business during some portion of the day; or

(ii) The employee is regularly employed by the employer in the performance of the service during the preceding calendar quarter.

(L) Remuneration for services performed by an officer or member of the crew aboard a vessel engaged in foreign, interstate, intercoastal, coastwide, or noncontiguous trade, including an officer or member of the crew of an airplane traveling between points in the State and points outside the State. An officer or member of a crew on a vessel in the coastwide trade between ports within the State, however, may reach a voluntary agreement with the employer to have tax withheld. Although not subject to withholding, remuneration for services performed by officers and crew members shall be reported on the recipient's respective state income tax return subject to section 235-7(a)(8), HRS.

(M) Noncash remuneration not in the course of trade or business. Remuneration for services not in the course of an employer's trade or business, including domestic services, to the extent paid in any medium other than cash. Unless otherwise provided in this section, the fair market value of the remuneration shall be stated separately on Form HW-2 or forms prescribed by the department. Although not subject to withholding, remuneration subject to this paragraph shall be reported on the income tax return of the recipient.

(N) Expense, allowances, etc. Amounts paid, either as advances or reimbursements, for traveling or other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer. To be excluded from withholding under sections 18-235-61-01 to 18-235-61-14, the traveling and other reimbursed expenses shall be identified as a separate payment, or shall be identified as separate amounts of ordinary wages and expense allowances which are combined into a single payment. Advances and reimbursements shall be separately stated on Form HW-2 or forms prescribed by the department, unless the employer requires an accounting by the employee showing that the amount does not exceed the ordinary and necessary expenses incurred in the business of the employer. Although not subject to withholding, payments subject to this paragraph shall be reported on the income tax return of the recipient.

(O) Noncash remuneration, retail salesperson. Noncash remuneration for services performed by a retail salesperson, where the services are ordinarily performed for commissions in cash. The employer must separately state the fair market value of this remuneration on Form HW-2 or forms prescribed by the department. Although not subject to withholding, remuneration subject to this paragraph shall be reported on the income tax return of the recipient.

(P) Remuneration for services performed as an employee by a duly ordained, commissioned, or licensed minister of a church in the exercise of the employee's ministry or by a member of a religious order in the exercise of duties required by the order. Although not subject to withholding, remuneration subject to this paragraph shall be reported on the income tax return as income of the recipient. For purposes of this paragraph, the term religious order is defined in Internal Revenue Service Procedure 91-20, 1991-1 CB 524. [Eff 2/16/82; am and ren §18-235-61-03 10/13/94; am 6/24/99] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61(e) **§18-235-61-04 Services performed by employees within and without the State.** (a) Resident employee. Wages earned by resident employees are subject to Hawaii income tax and are subject to withholding pursuant to section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14 regardless of where the services are performed. Therefore, even if the employee performs services out-of-state or for an employer which has an office in-state but is headquartered out-of-state, wages earned by a resident employee are subject to Hawaii income tax and withholding.

If wages earned by a resident employee also are taxed by another jurisdiction, a tax credit may be available under section 235-55, HRS.

(b) Nonresident employee.

(1) In general. Wages paid to a qualifying nonresident employee for services performed in the State are not subject to withholding. The wages, however, may be subject to Hawaii income tax as imposed by section 235-4, HRS.

An employee is a qualifying nonresident employee for purposes of section 235-61, HRS, and this section if:

(A) The employee is performing services in the State for an aggregate of not more than sixty days during the calendar year;

(B) The employee is a nonresident as set forth in section 235-1, HRS, or the employer reasonably believes the employee is a nonresident;

(C) The employee is paid for services performed from an office located outside the State;

(D) The employee's regular place of employment (where the employee regularly performs services for the employer) is outside the State; and

(E) The employer does not reasonably expect the employee to perform services in the State an aggregate of more than sixty days during the calendar year.

A qualifying nonresident employee does not include an employee performing services for a contractor as defined in section 237-6(1), HRS, and the contractor is performing work for a construction project located in Hawaii.

(2) Statement of nonresidency. To qualify for the exemption from withholding on wages as set forth in section 235-61, HRS, and this section, nonresident employees shall file a statement of nonresidency on forms prescribed by the department.

(A) Filing requirement. All nonresident employees may file a signed statement of nonresidency with their employer. The employer then shall file the original statement of nonresidency with the director or designee in the taxation district in which the employer's principal place of business is located or where services are principally performed. A copy of the form shall be retained in the records of the employer.

(B) Effective date. The employer shall cease withholding taxes from a nonresident employee's wages on or after the first payroll period or the first payment of wages after the statement of nonresidency is filed with the department.

(C) Investigation of nonresidency status. An employer, however, shall withhold taxes from the wages of a nonresident if the employer is notified by the department of an investigation into the nonresidency status of the employee. Notice of the investigation and the department's determination shall be sent to both the employer and the employee. The investigation into an employee's residency status shall be completed within a reasonable time. The department shall notify both the employee and the employer of the department's determination.

A notice of the department's determination shall be effective for the first payment of wages made on or after the first day of the calendar month which is at least thirty days after notice from the department is received. At the option of the employer, the department's determination may go into effect at an earlier payroll period.

(D) Change of status. If at anytime the employee's residency status changes, the employee shall notify the employer of the change in status within ten days. The employer then shall notify the department of the change in the employee's residency status. The change in status shall go into effect for the first payment of wages on or after the first day of the calendar month which commences at least thirty days after the department is notified. At the option of the employer, however, the change in residency status may go into effect at an earlier payroll period if the employee is notified of the change. [Eff 2/16/82; am and ren §18-235-61-04 10/13/94; am 1/29/99; am 9/20/99] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61(c) **§18-235-61-05 Payroll period.** (a) In general. Pursuant to section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14, an employer shall withhold taxes from wages paid to an employee for services rendered, unless otherwise exempted. The amount of tax the employer shall withhold from an employee's wages depends on the filing status of the employee, the number of exemptions the employee is eligible to claim, and the frequency of the payroll periods. The amount of tax shall be calculated by using the withholding tables or formula provided by the department.

(b) Daily payroll period. If an employee has a daily payroll period, the employer shall withhold taxes from the employee's daily wage. The employer shall use the daily or miscellaneous payroll period table provided by the department. However, if the wages are for a period of less than a week (seven days) and the employee verifies that the employee is not paid wages subject to withholding by any other employer during the same week, withholding may be calculated on a weekly payroll period basis.

(c) Miscellaneous payroll period. In order to calculate the amount of tax to withhold where an employee has either a miscellaneous payroll period, or has no payroll period, the employer shall:

(1) Count the number of days (including Sundays and holidays) in the period covered by the wage payment. If the wages are unrelated to a specific length of time (i.e., commissions paid upon completion of a sale), then the number of days in the wage payment shall be determined by counting the number of days from the date of the last payment to the date of the latter of: the last payment of wages made during the same calendar year; the date employment commenced (if during the same calendar year); or January 1 of the same calendar year.

(2) Determine the average wage per day by dividing the amount of the wage payment by the number of days covered by the wage payment.

(3) Compute the amount of tax to be withheld on the average wage per day by using the daily or miscellaneous payroll period table or formula provided by the department.

(d) Payroll period of less than a week. Where an employee is paid for a period of less than one week and signs a statement (subject to penalties set forth in section 231-34, HRS) verifying that the employee does not work for wages subject to withholding for any other employer during the same calendar week, then the employer is permitted to compute withholding based on a weekly payroll period, instead of a daily or miscellaneous payroll period. If an employer is eligible, but does not elect to use the weekly payroll period basis, the employer shall compute and withhold tax as if the aggregate amount of wages paid to the employee during the calendar week is for a daily or miscellaneous payroll period. An employer that elects to calculate withholding based on a daily or miscellaneous payroll period shall withhold, from each wage payment, an amount sufficient to ensure withholding of the correct amount of tax. If an employee subsequently begins work for wages subject to withholding for another employer, the employee shall notify the employer to which the employee gave the written statement within ten days. Thereafter, the employer must use the daily or miscellaneous payroll period table in computing the amount of tax to be withheld.

(e) Supplemental wages. If supplemental wages, such as bonuses, commissions, or overtime pay, are paid at the same time as regular wages, the amount of tax to be withheld shall be calculated based on the aggregate amount of supplemental and regular wages, as if it were a single wage payment for the payroll period.

If supplemental and regular wages are paid at different times, the employer may calculate the amount of tax to be withheld by aggregating the supplemental wages with either: the regular wages for the current payroll period, or the regular wages for the last preceding payroll period within the same calendar year. If supplemental wages are paid to an employee during a calendar year, for a period which includes two or more consecutive payroll periods, and other wages also are paid during the calendar year, the employer shall calculate the amount of tax to be withheld on the supplemental wages as follows:

(1) Determine the average wage for each payroll period by dividing the sum of the supplemental wages and the other wages paid for the payroll period by the number of payroll periods.

(2) To determine the amount of tax to be withheld from each payroll period, treat the average wage calculated in paragraph (1) as the amount of wages paid for the payroll period. The amount of taxes to be withheld shall be calculated by using the tables or formula provided by the department, given the length of the payroll period and the average wage paid for the payroll period.

(3) Lastly, from the sum of the taxes computed on the basis of the average wage per payroll period, subtract the sum of the taxes previously withheld or to be withheld from wages, other than supplemental wages, for the payroll periods. The balance, if any, constitutes the amount of the tax to be withheld from the supplemental wages. [Eff 2/16/82; am and ren §18-235-61-05 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61(c) **§18-235-61-06 Amount of tax to be withheld.** To determine the amount of tax to be withheld, the employer shall use either the tables or formula method provided by the department.

If the payroll period is a multiple of one week, other than biweekly, the employer shall determine the amount of tax to be withheld as follows:

(1) Determine the average weekly or biweekly wage for the particular payroll period;

(2) Compute the amount of tax to be withheld, based upon the average wage paid to the employee; and

(3) Multiply the amount of tax to be withheld per payroll period by the number of weeks in the payroll period.

If wages are paid on a quarterly, semiannual, or annual basis, the employer shall compute the amount of tax to be withheld by multiplying the average wage for one month by the number of months in the payroll period. [Eff 2/16/82; am and ren §18-235-61-06 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61(g) **§18-235-61-07 Additional withholding by agreement permissible.** The employer and employee may agree in writing to withhold an amount greater than, but not less than, the amount required under section 235-61, HRS and this section, and as calculated in the tables or formula method provided by the department. Any additional amount withheld shall be considered tax required to be deducted and withheld under section 235-61, HRS, and this section. [Eff 2/16/82; am and ren §18-235-61-07 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61 **§18-235-61-08 Returns and statements; Forms HW-14, HW-2, and HW-3.** (a) Each employer shall complete and furnish the following applicable returns as prescribed by sections 235-61 to 235-63, HRS, and the department, numbered and designated as follows:

HW-14 Withholding Tax Return;
HW-2 Statement of Hawaii Income Tax Withheld and Wages Paid; and
HW-3 Employer's Return and Reconciliation of Hawaii Income Tax Withheld From Wages.

(b) Form HW-14.

(1) In general. Pursuant to sections 235-62 and 235-63, HRS, every employer required to file a return of income tax withheld from wages shall file Form HW-14 or forms prescribed by the department, accompanied by payment of the tax withheld. Unless otherwise provided, the return shall identify the period covered by the return, the total wages paid by the employer in the period (including all wages, even though some wages may be excludable from withholding, such as wages paid to persons who are blind, deaf, or totally disabled), the total amount of taxes withheld in the period, and any other information which the director may require.

Employers that withhold income tax of $1,000 or more a year shall file Form HW-14 on a monthly basis; employers that withhold income tax of less than $1,000 a year may file Form HW-14 on a quarterly basis.

(2) Cease paying wages. Even if no wages are paid or an employer temporarily ceases to pay wages for any period (as in the case of seasonal business activity), the employer shall continue to file Form HW-14; the form shall indicate that no wages have been paid and that no taxes have been withheld.

If an employer ceases business permanently, the employer shall file a final Form HW-14 marked "Final Return" and Form HW-1A (Notification of Cancellation of Withholding).

(3) Where to file. Form HW-14 shall be filed in the taxation district where the employer's principal place of business is located or where services are principally performed. Nonresident employers shall file Form HW-14 with the Oahu District office. Form HW-14 shall be signed by the employer and shall be accompanied by payment of any taxes withheld from wages during the period.

(4) Filing due date. In general, monthly and quarterly filings of Form HW-14 are due on or before the fifteenth day of the calendar month which follows the period for which taxes are withheld. Where, however, an employer has a liability for taxes withheld in excess of $100,000 a year, the employer shall report and submit taxes on or before the tenth day of the calendar month which follows the period for which taxes are withheld.
For example, an employer that files Form HW-14 on a monthly basis shall report and submit taxes withheld during the month of January on or before February 15 of the same year.

(5) Change in filing. If the amount of taxes withheld by an employer increases to $1,000 or more or decreases below $1,000 a year, the employer shall notify the department on forms prescribed by the department. Accordingly, the employer shall change the frequency for filing Form HW-14 (from quarterly to monthly, or from monthly to quarterly).
Where the employer's liability for taxes withheld increases above or decreases to $100,000 or less, the employer shall notify the department on forms prescribed by the department. Accordingly, the employer shall file Form HW-14 by the appropriate date as set forth in this section.

(6) Electronic filing. Employers may substitute electronic filing, such as the use of magnetic tapes, computer printouts, or other approved media, for filing Form HW-14. Before any information is transmitted electronically, the employer shall file Form HW-25 or forms prescribed by the department and seek permission to file electronically. The consent of the director or designee must be received before electronic filing is permitted.

(7) Failure to file; failure to pay; underpayment of tax. An employer that fails to pay or underpays the tax liability, or that fails to file information as required under section 235-61, HRS, and sections 18-235-61-01 to 18-235-61-14 shall be subject to penalties and interest as set forth in section 231-39(b), HRS.

HRS §235-61 (c) Form HW-2. Provided all the required information is submitted, commercially printed forms or federal Form W-2 may be substituted for Form HW-2.

(1) In general. Every employer shall furnish Form HW-2 to:

(A) Every employee upon whose wages deduction and withholding is required;

(B) Every employee who is blind, deaf, or totally disabled even though the wages are not subject to withholding; and

(C) Every employee to whom wages subject to withholding (or payments under a wage continuation plan) have been paid in any period during the calendar year (or period of employment).

(2) Information provided. Each Form HW-2 must show the following information relating to wages earned by and taxes withheld from an employee during the calendar year for which the HW-2 is issued: the employee's name, address, and social security number, if any; the employer's name, address, and Hawaii withholding identification number; and time period covered by the statement; the total amount of wages paid to the employee during the time period, including wages which are not subject to withholding, such as wages paid to a person who is blind, deaf, or totally disabled; the amount of income tax deducted and withheld, if any; and such other information as the director may require. Noncash remuneration, and advances or reimbursements for expenses and the like, must be separately stated on Form HW-2 or forms prescribed by the department. The form must be furnished to both the employee and the director or designee. Federal Form 1099 also may be used for this purpose. If the total amount of noncash remuneration, advances, and reimbursements, together with the wages subject to withholding and payments under wage continuation plans, total more than the amount of one withholding exemption for any period, then a separate Form HW-2 or forms prescribed by the department must be furnished for each type of payment.

(3) If a separate form is used, it must include any wages subject to withholding (or payments under a wage continuation plan) not reported on Form HW-2 or forms prescribed by the department and filed with the director or designee.

(4) Filing date; forms. Every employer shall provide each employee that it employed during the preceding calendar year with copies B and C of Form HW-2 by January 31 of the following calendar year. If, however, an employee ceases to work for an employer before the calendar

year ends and is not expected to return for the remainder of the calendar year, the employee may submit a written request to the employer requesting copies B and C of Form HW-2 before January 31 of the following calendar year. Upon receiving the written request, the employer shall provide the HW-2 statements within thirty days or by January 31 of the following calendar year, whichever is earlier.

HRS §235-61 (d) Form HW-3. Form HW-3 (Employer's Return and Reconciliation of Hawaii Income Tax Withheld from Wages) shall show the following information:

(1) The employer's name, address, and Hawaii withholding identification number;
(2) The total wages paid to employees (including cost of living allowance, sick pay, and wages paid to a person who is blind, deaf, or totally disabled);
(3) The total wages subject to withholding that are paid to employees;
(4) The amounts of tax withheld from employees' wages, as shown on these forms;
(5) The amount of tax remitted to the department, as reported monthly or quarterly on Form HW-14;
(6) Total payments made during the calendar year; and
(7) Other information as the director may require.

The employer shall remit any discrepancy between the total amount of tax withheld from all employees' wages during the preceding calendar year and the amounts remitted to the department as reported monthly or quarterly on Form HW-14.

(e) Reconciliation of taxes withheld; Forms HW-2 and HW-3. Each employer shall file with the department, on or before the last day of February following the close of the calendar year, Copy A of Form HW-2 issued for the preceding calendar year, and copies 1 and 2 of Form HW-3.

If an employer submits more than one Form HW-2, the employer shall attach a list of the amounts of income tax withheld, as stated in the HW-2 forms.

(1) Separate divisions. If an employer's total payroll covers a number of separate divisions, the employer may separate and submit the HW-2 forms by divisions. A summary list must be submitted, along with each division's HW-2 forms, and the figures shall be reported on the employer's HW-3 form. The total of all tax withheld by the divisions shall correspond with the entry made on Form HW-3.
(2) Large number of forms. Where an employer submits a large number of HW-2 forms, the forms may be forwarded to the department in packages of convenient size. The packages shall be identified with the employer's name, Hawaii withholding identification number, and shall be consecutively numbered; Form HW-3 shall be placed in the first package.
(3) Employer goes out of business. If an employer goes out of business or permanently ceases to pay wages, the employer shall file Form HW-3 with accompanying HW-2 statements at the same time the final Form HW-14 return is filed. The final Form HW-14 shall be marked "Final Return". The employer also shall file Form HW-1A.
(4) Extension of time to file. Upon application by an employer, the director may grant an extension of time of not more than two months for filing Form HW-3 and the accompanying statements and list. Except in a case of termination of business or the like, an application for an extension of time must be filed on or before the last day of February.
(5) Amendment of Forms HW-2 and HW-3. An employer may amend incorrectly filed Forms HW-2 and HW-3. Amendments shall be made on forms prescribed by the department. Amendment of Forms HW-2 and HW-3 shall be made within three years from the date the form is due or three years after the form is filed, whichever is later.
If Form HW-2 is amended and the amendment occurs prior to the filing of Form HW-3 for the taxable year, the employer shall submit the amended Form HW-2 at the time Form HW-3 is filed. If, however, the amendment of Form HW-2 occurs after Form HW-3 for the taxable year has been filed, the employer shall submit the amended HW-2 with Form HW-23 ("Amended Employer's Return and Reconciliation of Hawaii Income Tax Withheld from Wages") or on forms prescribed by the department.

(f) Use of single return form for more than one employer. Except as provided in sections 18-235-61-01 to 18-235-61-14 and subject to the approval of the director or designee, a single return may comprise the monthly withholding tax return of more than one employer where the employers have been permitted to file the required tax information electronically.

(1) Authorization.
(A) The return may be made by an agent for or on behalf of the employer required to make the return. Each agent filing a single return for more than one employer shall include, with each return, a list of the participating employers.

(B) The agent filing the single return first shall seek approval of the director or designee, on forms prescribed by the department, to file the return as agent for more than one employer.

(C) The agent shall obtain a power of attorney, acceptable to the director or designee, from each employer which it represents and the power of attorney shall be filed with the director or designee. The power of attorney shall authorize the agent to sign the return, verify by written declaration that the return is made under penalties of perjury and in accordance with law, file the required return, and direct payment of the employer's payroll taxes.

(D) The agent shall keep and maintain a copy of each power of attorney until the power has been revoked by the respective employer.

(E) The agent shall notify the director or designee if a power of attorney is revoked and the effective date of the revocation, at least five days prior to the due date of the return. Notification of the revocation shall be made and filed as prescribed by the department.

(2) Form of return.

(A) Employers or their agents may file the monthly or quarterly withholding tax return information on computer printouts, magnetic tapes, or other media approved by the director or designee. To seek approval, employers or their agents shall file the appropriate form prescribed by the department.

(B) Whenever magnetic tapes are used as attachments, the tape shall be in the magnetic tape format utilized by the department.

(C) The withholding tax information submitted on computer printouts, magnetic tapes, etc., shall include all information which is required on Form HW-14. In addition, a list of the employer identification numbers in numerical sequence, the name of each employer, and any other information the director or designee may require shall be attached to the computer printouts, magnetic tapes, etc.

(D) All computer printouts, magnetic tapes, and other approved media shall conform to the requirements of the department and as set forth in this section.

(E) The director, from time to time, may change the requirements or the required forms as needed.

(3) Filing. The return shall be deemed properly filed upon submission of the information required by the department.

(4) Payment.

(A) The tax withheld shall be due and payable at the time the withholding tax return information is filed with the department. One copy of the withholding tax return information shall be filed with the department; a second copy shall be stamped upon receipt of payment and returned to the employer or agent.

(B) Each agent filing the return permitted by this section shall pay the taxes in full by cash, cashier's check, or certified check. [Eff 2/16/82; am and ren §18-235-61-08 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61(f) **§18-235-61-09 Withholding exemptions.** (a) In general. In order for an employer to determine the correct amount of taxes to withhold from an employee's wages, each employee shall complete Form HW-4 (Withholding Exemption and Status Certificate) or forms prescribed by the department for each employer who is required to withhold taxes from the employee's wages. Form HW-4 shall show the employee's marital status, the number of exemptions the employee qualifies for, the employee's address, social security number, and signature. If an employee does not furnish Form HW-4 to the employer, the employer shall withhold tax as if the employee is single and claims no withholding exemption. At the election of the employer, commercially printed forms substantially the same as Form HW-4 may be used. However, federal Form W-4 may not be used.

(b) Exemptions claimed by employee. The number of withholding exemptions claimed by an employee shall not exceed the number of exemptions for which the employee qualifies. If the employee is married, the employee may claim any exemptions to which the employee's spouse is entitled, but only if the employee's spouse has not already claimed the exemptions.

(c) No Form HW-4 in effect. The first HW-4 form furnished by the employee shall be effective for the first payroll period ending on or after the date on which the form is furnished to the employer. If wages are paid without regard to a payroll period, Form HW-4 shall be effective for the first payment of wages on or after the date on which it is furnished to the employer.

(d) Amending Form HW-4; effective date. If an employee chooses to amend an existing Form HW-4, it shall be effective no later than the first payment of wages made on or after the thirtieth day after the amendment is

made. If wages are paid without regard to a payroll period, then Form HW-4 shall be effective for the first payment of wages. At the election of the employer, however, Form HW-4 may be made effective prior to this date.

(e) Change in exemption status, number of exemptions. In general, if the number of exemptions the employee may claim increases, Form HW-4 may be amended to reflect the change. If, however, the number of exemptions the employee may claim decreases, or there is a change in the taxpayer's marital status, the employee shall amend Form HW-4 to reflect the change within ten days after the change occurs.

Where changes do not affect the amount of tax to be withheld until the next calendar year (i.e., death of a spouse or dependent), the employee shall amend Form HW-4 filed with the employer on or before December 1 of the year in which the change occurs. If the change occurs in December, the employee shall amend Form HW-4 within ten days after the change occurs.

If an employee no longer qualifies for a complete exemption from income tax withholding, an amended Form HW-4 shall be filed to reflect the change and allow for withholding of taxes. [Eff 2/16/82; am and ren §18-235-61-09 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61 **§18-235-61-10 Employer's identification number.** An employer shall apply for an employer identification number with the department on forms prescribed by the department. Each employer shall be assigned only one identification number. The director, however, may require separate identification numbers for separate divisions of an employer's business, or for services performed not in the course of the employer's trade or business. The identification number assigned to an employer shall be used on all applications, returns, payments, statements, forms, and correspondence with the department. [Eff 2/16/82; am and ren §18-235-61-10 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61 **§18-235-61-11 Taxation district in which to file.** All applications, returns, payments, statements, forms, and correspondence the employer is required to file with or submit to the department, including any information required of the employee relating to employment and the payment of taxes, shall be filed with the director or designee in the taxation district in which the employer's principal place of business is located. Where an employer is a nonresident and has no place of business in the State, all filings and submissions shall be made to the director or designee in the first taxation district of Oahu. [Eff 2/16/82; am and ren §18-235-61-11 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61 **§18-235-61-12 Statutory period.** Where monthly or quarterly returns must be filed under section 235-62, HRS, and a final return for the taxable year showing the reconciliation of wages is required, the statutory period of limitation shall commence upon the filing of the final return for the taxable year or the due date of the final return, whichever is later. [Eff 2/16/82; am and ren §18-235-61-12 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61 **§18-235-61-13 Records.** (a) In general. Every employer that becomes subject to section 235-61, HRS, is required to keep full, complete, regular, and accurate records pertaining to the withholding of taxes. Every employer also shall keep records of each adjustment or settlement of income tax withheld under section 235-61, HRS, and made pursuant to sections 18-235-61-01 to 18-235-61-14. The records shall be available for inspection by the director. Every employer also shall maintain a record of the current addresses of all employees at all times; each employee must furnish a current address to the employer.

(b) Records in connection with collection of income tax at source on wages. Every employer required to deduct and withhold income tax upon the wages of employees pursuant to section 235-61, HRS, and this section shall keep records of all remuneration paid to such employees.

For purposes of this section, "remuneration" includes all payments, whether in cash or in a medium other than cash. The record keeping requirements of this section, however, are not required for noncash payments for services performed not in the course of the employer's trade or business, and tips received by an employee in a medium other than cash or of an amount less than $20 for a calendar month.

The employer's records shall contain the following information about each employee:

(1) The name, address, and social security number of the employee;
(2) The total amount and date of each payment of remuneration (including any sum withheld as tax or for any other reason) and the period of time covered by the payment;
(3) The amount of the remuneration payment which constitutes wages subject to withholding;
(4) The amount of tax collected with respect to the remuneration payment and the date the tax was collected, if the tax was collected at a time other than when the payment was made;
(5) If the total remuneration payment differs from the amount from which tax has been withheld, the reason for the difference in amounts shall be provided by the employer;

(6) The fair market value and date of each payment of noncash remuneration made to an employee, for services performed as a retail commission salesperson from which no income tax was withheld;

(7) The withholding exemption certificate (Form HW-4) filed with the employer by the employee;

(8) Any agreement between the employer and the employee for the withholding of additional amounts of tax;

(9) With respect to employee performed services which are not performed in the course of the employer's trade or business, the employer shall maintain sufficient records detailing, by quarter, the dates the services were performed and the amount of cash remuneration paid for the services performed; and

(10) Where an employee receives tips in the course of the employee's employment, the employer shall maintain records of tips received by the employee, including copies of any statements furnished by the employee. [Eff 2/16/82; am and ren §18-235-61-13 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

HRS §235-61 **§18-235-61-14 Change of ownership; transfer of business; employer going out of business.** An employer must notify the director or designee if there is a change in the business, including: a sale or other transfer of the business; the employer is going out of business; the employer or business has a change of address; or the name of the business changes. [Eff 2/16/82; am and ren §18-235-61-14 10/13/94] (Auth: HRS §§231-3(9), 235-61, 235-118) (Imp: HRS §§235-61 to 235-67)

§18-235-62 to 18-235-65 (Reserved)

HRS §235-61 **§18-235-66 Further withholdings at source; crediting of withheld taxes.** (a) (Reserved)

(b) Credit for tax withheld upon income. Taxes withheld at the source pursuant to section 235-66, HRS, or sections 235-61 to 235-66, HRS, shall be credited against the taxpayer's income tax liability. Where taxes are withheld by an employer against wages paid during any calendar year pursuant to sections 235-61 to 235-66, HRS, the tax liability of the recipient of the income shall be credited for the amount of tax withheld for the taxable year during which the calendar year began. If the taxpayer has more than one taxable year beginning during the calendar year, the credit shall be applied against the tax liability resulting from the last of the taxable years. Taxes withheld shall be deemed payments of estimated taxes under section 235-97(g), HRS.

(1) For purposes of this section, "recipient of the income" is the person who is subject to tax under chapter 235, HRS, upon the wages or other income from which the tax is withheld.

(2) Withholding on income. Tax is considered withheld at the source if:

(A) The tax has actually been deducted and withheld from the income or wages, even if the employer or person required to withhold the tax has not submitted it to the State; or

(B) The tax has been paid to the State by the employer or person required to withhold the tax, and the recipient of the income has actually reimbursed the amount to the employer or person required to withhold it.

(3) Application of credit. After the taxpayer has determined the amount of tax for the taxable year, the credit for taxes withheld is applied by the taxpayer against the tax liability to determine whether there is a balance due or whether the return shows an overpayment. An overpayment of tax may be used as a credit against the taxpayer's estimated tax for the succeeding taxable year or may be refunded pursuant to section 235-110, HRS. [Eff 2/16/82; am 7/23/94] (Auth: HRS §§231-3(9), 235-66, 235-118) (Imp: HRS §235-66)

§18-235-67 (Reserved.)

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SUBCHAPTER 4

CORPORATION INCOME TAX

HRS §235-71 **§18-235-71 Tax on corporations; rates; credit of shareholder of regulated investment company.** (a) (Reserved)

(b) Federal Treasury regulations relating to the Internal Revenue Code provisions of regulated investment companies shall apply and the imposition of tax and deductions for dividends paid shall be as provided under section 235-71, HRS.

(c) Undistributed capital gains of a regulated investment company. Section 235-71, HRS, provides that a shareholder of a regulated investment company is allowed a credit equal to the amount of tax imposed on capital gains which are includable in the shareholder's income tax return under section 852(b)(3)(D), IRC, (taxation of regulated investment companies and their shareholders) limited to the amount of tax paid by the regulated investment company at the state capital gain rate to the State. The credit shall be applied against the shareholder's tax liability as determined under chapter 235, HRS. Any excess amount shall be applied or refunded to the shareholder pursuant to section 235-110, HRS.

(d) Real estate investment trust; in general.

(1) Federal Treasury regulations relating to Internal Revenue Code provisions on real estate investment trusts shall apply and the imposition of tax and deductions for dividends paid shall be as provided under section 235-71, HRS.

(2) Real estate investment trust; penalties. In addition to any other penalty provided by law, the assessable penalties with respect to liability for tax of real estate investment trusts shall be as provided under section 235-71, HRS and as follows:

(A) The interest and penalty are determined based on the amount of adjustment, but only to the extent that the deficiency dividend deduction is allowed; and

(B) The nondeductible penalty is equal to the amount of interest for which the trust is liable on account of such adjustment.

The total penalty, however, is limited to one-half the amount of the deficiency dividend deduction. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-71)

§18-235-72 (Reserved)

SUBCHAPTER 5

(RESERVED)

SUBCHAPTER 6

RETURNS AND PAYMENTS; ADMINISTRATION

HRS §235-92 **§18-235-92 Returns, who shall make.** (a) Individual returns.

(1) Who is required to file. Pursuant to section 235-92, HRS, for each taxable year, a return shall be filed by:

(A) Every individual doing business in the State during the taxable year, whether or not any taxable income is derived therefrom. As used in this paragraph, "doing business" includes all activities engaged in or caused to be engaged in with the object of gain or economic benefit, direct or indirect, with the exception of personal services performed as an employee under the direction and control of an employer. Every person receiving rent from property owned in the State is deemed to be doing business and shall file a return, whether or not taxable income is derived from the activity.

(B) Every individual receiving gross income in excess of the total amount of any personal exemptions which the taxpayer may claim and the standard deduction.

(C) Every individual claiming benefits available to individuals taking up residence in Hawaii after attaining the age of sixty-five years and before July 1, 1976. The return

should be accompanied by a signed statement setting forth the date that the individual established residence in Hawaii and the individual's date of birth.

(D) Children receiving income during the taxable year who have not attained the age of fourteen years before the end of the taxable year. The income of a minor child is not included in the gross income of the parent for income tax purposes, except as provided in section 235-7.5, HRS. The minor child's income shall be reflected in the return filed by or for such child.

(2) Filing of returns though not required. Even though a taxpayer is not required to file a tax return for the taxable year under paragraph (1), a return must be filed in order to support a claim for a credit or refund. However, filing a return is not required in order to obtain a refund of tax withheld upon wages of an individual who files a Form HW-6 claiming nonresidency, notwithstanding any notice issued by the director regarding investigation of the individual's residence status.

(b) Forms N-12 and N-15. An individual taxpayer shall report taxable income on Form N-12 or N-15, except where a taxpayer qualifies for and elects to use Form N-13.

The taxpayer shall determine whether to use either Form N-12 or N-15 based on where the taxpayer's residence is located.

Whether Form N-12 or N-15 is used, there shall be attached to the return, Copy B of all HW-2 forms received by the taxpayer with respect to tax withheld during the calendar year in which the taxable year of the taxpayer began.

(c) Form N-13. In general, an eligible taxpayer may file Form N-13 in lieu of Form N-12. An eligible taxpayer who has received an extension to file a return pursuant to section 18-235-98, after December 31, 1993, also may file Form N-13 in lieu of Form N-12. Copy B of all HW-2 forms received by the taxpayer reporting taxes withheld during the taxable year shall be attached to the return filed with the department.

(1) Taxpayers eligible to file Form N-13. A taxpayer is eligible to file Form N-13 if:

(A) The taxpayer's taxable income is less than $50,000 for the taxable year;

(B) The taxpayer's gross income consists entirely of wages, salaries, tips, interest, ordinary dividends, and unemployment compensation;

(C) No interest or dividends are received by the taxpayer as a nominee for another individual;

(D) The taxpayer did not make any estimated tax payments;

(E) The taxpayer is a resident of the State;

(F) The taxpayer does not claim any itemized deductions;

(G) The taxpayer does not claim any adjustments to income, including any exclusion from income due to military reserve or Hawaii national guard duty pay;

(H) The taxpayer does not claim any credit for taxes paid to other jurisdictions under chapter 235, HRS, or for taxes with respect to any capital gains distribution;

(I) The taxpayer uses the cash accounting method and files returns on a calendar year basis;

(J) The taxpayer claims the special exemption for blindness, deafness, or total disability as set forth in section 235-54(c), HRS; and

(K) The taxpayer's spouse does not file separately and itemize deductions, except for those spouses which live apart (and abandoned spouses) who have dependent children.

(2) Joint returns. In general, joint returns shall be filed pursuant to section 235-93, HRS, and section 18-235-93. Joint returns filed on Form N-13 also shall be subject to the limitations set forth in paragraph (1). The aggregate taxable income for the taxable year of the spouses filing a joint return shall be less than $50,000. If either spouse does not qualify as a taxpayer eligible to file Form N-13, no joint return shall be filed on Form N-13. Additionally, both spouses shall sign any jointly filed Form N-13; similar to other joint returns filed pursuant to chapter 235, HRS, the liability is joint and several.

(3) Computing the tax. If a taxpayer completes a Form N-13 including the computation of taxable income, the taxpayer may file the Form N-13 and request the department of taxation to compute the amount of tax owed by the taxpayer. The department, however, shall not compute tax credits for the taxpayer. If the taxpayer chooses to claim tax credits, the taxpayer shall complete the tax credit portion of Form N-13 and all forms required to claim the tax credits; the required forms shall be submitted to the department with Form N-13. Upon receipt of Form N-13 and all forms required to claim tax credits, if any, the department of taxation will compute the tax owed by or refund owed to the taxpayer from the tax tables as provided in section 235-53, HRS. The department shall mail a notice of the amount of tax owed by or the amount of refund due to the taxpayer. Payment of any tax owed by

the taxpayer shall be made within thirty days of the mailing of the notice. For purposes of determining delinquent taxes, penalties, and interest with respect to the payment of tax, the thirty day period after the mailing of the notice of the tax liability shall be deemed the time allowed by law for the payment of the tax.

(d) Consolidated returns.

(1) Who may file a consolidated return. Only an "affiliated group" of corporations, as defined by section 1504, IRC, (consolidated returns), may file a consolidated Hawaii income tax return. In addition to the federal requirements, each corporation included in the affiliated group must be organized under the laws of the State of Hawaii and for the taxable year, have gross income subject to tax under chapter 235, HRS.

Example 1: K owns eighty per cent of the stock of M and N. N owns one hundred per cent of the stock of O. As defined in section 1504, IRC, K, M, N, and O are all members of an affiliated group and may file a consolidated return.

Example 2: D owns eighty per cent of E. E owns eighty per cent of F. E and F each own forty per cent of G, D, E, F, and G are all members of an affiliated group and may file a consolidated return.

(2) How to elect. Any corporation in an affiliated group, as set forth in paragraph (1), may elect to join in a consolidated return filing. Each corporation included in the consolidated return shall signify its consent by filing Form N-303. The consolidated return, with Form N-304 (affiliation schedule) attached, shall be filed not later than the last day prescribed by law (including extensions of time) for the filing of the common parent's return. The affiliated group may not withdraw its consolidated filing after the last day to file, but may switch to separate returns at any time prior to the due date.

(A) An affiliated group which files (or is required to file) a consolidated return for a tax year shall continue to file a consolidated return for the affiliated group until such time as the affiliated group receives permission to discontinue filing a consolidated return from the director of taxation.

(B) Form N-303 must be filed for each corporation in an affiliated group only in the first taxable year the affiliated group files a consolidated return. Thereafter, any additions to or deletions from the affiliated group shall be reported to the department on form N-303; the form must be attached to the consolidated return for the taxable year in which the corporation joins or withdraws from the affiliated group.

(3) Separate returns. Once an election to file a consolidated return has been made, the affiliated group shall continue to file consolidated returns until the director of taxation gives written permission to discontinue the filing of consolidated returns. An application to discontinue filing consolidated returns shall be submitted by the parent organization at least ninety days prior to the filing due date of the consolidated return, including extensions of time. The application shall state the reasons for discontinuing consolidated filing.

(4) If an affiliated group files a consolidated return, it must also file and pay estimated tax on a consolidated basis until permission to discontinue consolidated filing is received from the director of taxation or designee. [Eff 2/16/82; am 6/28/93; am 1/1/94; am 10/13/94] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-92)

HRS §235-93 **§18-235-93** **Joint returns.** (a) In general. A husband and wife, as defined in section 235-1, HRS, may file a single joint return. A joint return may be filed even though one of the spouses has neither gross income nor deductions, and even though the spouses are not living together at any time during the taxable year, except as provided below:

(1) No joint return shall be filed if the spouses are legally separated under a decree of divorce or of separate maintenance;

(2) No joint return shall be filed if either spouse is a nonresident alien at any time during the taxable year; provided that section 6013(g), IRC, (joint returns of income tax by husband and wife) relating to the election to treat a nonresident alien individual as a resident of the United States is incorporated by reference and the election under the IRC shall be accepted as an election for the purposes of chapter 235, HRS;

(3) No joint return shall be filed if the husband and wife have different taxable years, except that if the spouses' taxable years begin on the same day and end on different days because of the death of either or both, then a joint return may be filed with respect to their taxable

year. This exception shall not apply if the surviving spouse remarries before the close of the surviving spouse's taxable year, or if the taxable year of either spouse is a fractional part of a year due to a change of accounting period;

(4) In the case of the death of one or both spouses, the decedent's joint return may be filed only by the executor or administrator of each decedent's estate, except that in the case of the death of one spouse a joint return may be made by the surviving spouse with respect to both the surviving spouse and the decedent if no return for the taxable year has been made by the decedent, no executor or administrator has been appointed, and no executor or administrator is appointed before the last day for filing the return of the surviving spouse. If an executor or administrator of the decedent is appointed after the filing of a joint return by the surviving spouse, the executor or administrator may disaffirm the joint return filing by filing a separate return for the decedent's taxable year within one year after the last day for filing a return of a surviving spouse. The return filed by the surviving spouse shall constitute the surviving spouse's separate return;

(5) No joint return shall be filed if either spouse is a nonresident (i.e., resident of another state), unless the nonresident spouse agrees to subject all sources of income to Hawaii income tax.

(b) Effect of filing a joint return. For any taxable year in which husband and wife have filed a joint return, separate returns may not be made by either of the spouses after the date for filing the return of either spouse has passed. However, an executor or administrator may disaffirm a joint return as set out in subsection (a)(4).

If a joint return has been filed, the liability of the spouses is joint and several; therefore, any refund checks issued based on the filing of a joint return shall be in the names of both spouses, even if the spouses separate or divorce before the refund is issued. Divorced spouses continue to be jointly and severally liable for those taxable years for which they filed a joint return.

All or part of an overpayment from a joint return may be retained by the department to offset any delinquent tax liability of the taxpayers. Where the delinquent tax liability is a separate tax liability of one of the taxpayers, only that taxpayer's proportionate share of the overpayment shall be retained. A married taxpayer's proportionate share of the overpayment shall be based on the taxpayer's respective tax liability, calculated as if each married taxpayer had filed their respective tax returns separately.

In order to determine a married taxpayer's proportionate share of the tax liability, the amount of the joint tax liability shall be multiplied by the ratio of the taxpayer's tax liability (calculated as if the taxpayer had filed separately) as it bears to the total tax liability of the taxpayers (calculated as if both taxpayers filed separately). From the information available on the joint return, the department shall allocate the income, deduction, and credit items to the appropriate individual taxpayer, in order that they may calculate their separate tax liabilities. Income, deduction, and credit items which the department cannot trace to either taxpayer, from the information filed by the taxpayers, shall be allocated equally between the taxpayers. Taxpayers may dispute the department's allocation of any income, deduction, or credit item upon presentation of sufficient evidence to the director of taxation. The director of taxation shall make the appropriate adjustment to the allocation and refund.

Example: A and B are married and earn income of $20,000 and $30,000, respectively. For 1990, A and B agree to file a joint tax return.

Notwithstanding their joint tax liability of $3,825 for 1990 (using the tax tables set forth in section 235-51, HRS), B owes a separate delinquent general excise tax liability from a prior year of $750. Withholding in 1990 from A's wages totaled $1,500; withholding in 1990 from B's wages totaled $2,500. Deductions of $2,000 are not directly traceable to either spouse; an additional $500 in deductions are traceable to A.

The amount of tax liability owed by A and B shall be determined based on their proportionate tax liability, calculated as if they had filed separately. In this case, A's tax liability, calculated as if A had filed separately, is $1,445; B's tax liability, calculated as if B had filed separately, is $2,387.50. A and B's proportionate share of the joint tax liability is calculated as follows:

$$\frac{\text{A/B tax liability, calculated as if filing separately}}{\text{A's separate tax liability + B's separate tax liability}} \times \text{joint tax liability}$$

A and B's share of the tax liability is equal to the amount withheld from A/B minus A/B's proportionate share of the joint tax liability. Therefore:

A's share of the refund $\frac{1,445}{3,285.50}$ x 3,285 = $1,442.17
1,500-1,442.17 = $57.83

B's share of the refund $\frac{2,387.50}{3,285.50}$ x 3,825 = $2,382.83
2,500-2,382.83 = $117.17

Therefore, the department may retain B's share of the refund, or $117.17, to offset B's separate delinquent general excise tax liability.

In the case of divorced taxpayers, all or part of an overpayment from any joint return filed during the period of marriage also may be retained to offset any separate delinquent tax liability of either divorced taxpayer.

(c) Computation of taxable income. The tax on a joint return is computed based on the aggregate income of the spouses. The gross income, adjusted gross income, deductions allowed, and taxable income are computed aggregately. Deductions limited to a percentage of adjusted gross income, such as the deduction for charitable contributions, are computed based on the aggregate amount of adjusted gross income. Similarly, losses resulting from the sale or exchange of capital assets are aggregated and the limitation on the loss deduction is applied against the combined taxable income of the spouses; the maximum loss deduction allowance shall be applied to the aggregate income of both spouses.

(d) Joint return after filing separate return. Except as provided in subsection (e), an individual who has filed a separate return for a taxable year in which a joint return could have been filed pursuant to section 235-93, HRS, may nevertheless file a joint return if the time prescribed by law for filing the return for the taxable year has not expired. If a joint tax return is filed by a husband and wife under this subsection:

(1) The return shall constitute the tax return of the husband and wife for the taxable year;
(2) All payments, credits, or refunds made or allowed with respect to the separate return of either spouse for the taxable year shall be taken into account in determining the balance of tax owed based on the joint liability;
(3) Any election (other than the election to file a separate return) made by either spouse in their separate return for the taxable year with respect to the treatment of any income, deduction, or credit, shall not be changed in the filing of the joint return where the election would have been irrevocable had the joint return not been made; and
(4) After the death of either spouse, only the executor or administrator of the decedent may file a joint tax return on the decedent's behalf.

(e) When joint return may not be filed after separate returns have been filed. The election to file jointly after separate returns have been filed may not be made:

(1) Unless the joint tax liability is paid in full at or prior to the filing of the joint return;
(2) If a final assessment of income tax of either spouse for a taxable year has been made (for purposes of this section, a notice of proposed assessment does not constitute an assessment);
(3) If either spouse, for the taxable year, has entered into a closing agreement under section 231-3(13), HRS, or a compromise of tax liability under section 231-3(10), HRS; or
(4) If the requirements of subsection (f) are not met.

(f) Limitation period.

(1) A joint return under subsection (d) must be filed within three years from the last date prescribed by law for filing the return for the taxable year, determined without regard to any extension of time granted to either spouse. The date of filing of the first of the separate returns of the spouses shall be deemed the filing date of the joint return.
(2) The filing of a joint return after separate returns have been filed does not extend the limitation period prescribed in section 235-111, HRS. The period, however, may be extended by agreement between the taxpayers and the director of taxation as provided in section 235-111(c), HRS.
(3) A joint return may not be filed under subsection (d) more than three years after the date of filing of the first of the separate returns of the spouses unless the joint return is accompanied by an agreement between the taxpayers and the director of taxation, extending the period of time as prescribed in section 235-111(c), HRS. If such an agreement no longer can be made because the three year period of time prescribed in section 235-111, HRS, has expired, the joint return may not be filed.

(g) Additions to the tax. Where a husband and wife file a joint return under subsection (d) after filing separate returns and the joint liability exceeds the aggregate amount of taxes due on the separate returns of the spouses

or exceeds the amount shown as tax on the separate return of one of the spouses, the penalties and interest applicable to the separate return of either spouse, under section 231-39, HRS, or to the failure, neglect, or refusal of either spouse to make, authenticate, or file an income tax return by the due date are not eliminated as a result of the election to make a joint return. Additionally, any penal offense of either spouse in relation to any separate return filed is not eliminated as a result of the election to make a joint return. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-93)

HRS §235-94 **§18-235-94 Estate and trust returns.** (a) In general. Pursuant to section 235-94(d), HRS, the fiduciary of an estate or trust is required to file an income tax return for the estate or trust and pay any tax liability due on the taxable income.

(b) Filing of estate and trust returns. The fiduciary of an estate or trust shall file an income tax return for each taxable year, reporting income subject to taxation under chapter 235, HRS, if:

(1) An estate has taxable income of $400 or more;

(2) A trust, which under its governing instrument is required to distribute all of its income currently, has taxable income of $200 or more; or

(3) Any other trust which has taxable income of $80 or more.

If a nonresident trust or estate is doing business in the State or has income from sources in the State, the fiduciary shall file an income tax return for the trust or estate subject to the limitations set forth in this subsection.

(c) Where to file. The return shall be filed by the fiduciary for the taxable year with the director of taxation or designee for the taxation district in which the residence or principal place of business of the fiduciary is located. If the fiduciary has no residence or place of business in the State, then the return shall be filed with the director of taxation in Honolulu.

(d) Filing date. The return shall be filed on or before the twentieth day of the fourth month following the close of the taxable year and shall be accompanied by payment of the tax liability. [Eff 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-94)

§18-235-94.5 (Reserved)

HRS §235-95 **§18-235-95 Partnership returns.** (a) Filing returns.

(1) In general. Except as provided in subsection (b) with respect to certain organizations excluded from the application of chapter 1 (subchapter K) of the Internal Revenue Code of 1986, as amended, and certain partnerships having no business in the State, an unincorporated organization defined as a partnership in section 761, IRC, (partnership defined), through or by means of which any business, financial operation, or venture is carried on, shall file a return for each taxable year as prescribed by the department. Every partnership engaging in trade or business, or having income from sources within the State, shall file a partnership return pursuant to section 235-95, HRS, and this section, regardless of the partnership's principal place of business or the residency status of the partners. A partnership return shall be filed in the first year the partners formally agree to engage in joint operation, or in the absence of a formal agreement, the first taxable year in which the organization receives income or makes or incurs any expenditures treated as deductions for Hawaii income tax purposes. The partnership return shall include and state specifically: gross income of the partnership; allowable deductions; the names and addresses of all partners; and the amount of the distributive shares of income, gain, loss, deduction, or credit allocated to each partner.

(2) Exception. Special election; in general. An unincorporated organization may elect to be excluded from the application of subchapter K if the organization is used for:

(A) Investment purposes only and does not actively conduct business activity;

(B) The joint production or use of property (including natural resources), but not for the sale of services or property which is produced; or

(C) Underwriting, selling, or distributing a particular issue of securities by securities dealers for a short period of time.

Any unicorporated organization excluded from the application of part of subchapter K shall file a Form N-20 and provide such information as the director of taxation or designee may require.

(3) Making the election. If an unincorporated organization qualifies and elects to be excluded from the application of subchapter K, the following information must be attached to, or incorporated in, a properly executed partnership return in lieu of the usual tax information, in the first taxable year in which exclusion is desired:

(A) The name or other identification and the address of the organization, together with information on the return;
(B) The names, addresses, and identification numbers of all the members of the organization;
(C) A statement describing the activities of the organization that qualify it for exclusion from section 761, IRC;
(D) A statement that all members of the organization elect to be excluded from subchapter K; and
(E) A statement indicating where a copy of the agreement under which the organization operates is available, or if the agreement is oral, from whom the provisions of the agreement may be obtained.

Thereafter, if the election remains in effect, annual partnership tax returns need not be filed.

(4) Failure to make election. If an unincorporated organization does not make the election as prescribed by this section, the organization shall nevertheless be deemed to have made the election if it can be shown from all the facts and circumstances that at the time of its formation, the members of the organization intended to secure exclusion from all of subchapter K, beginning with the first taxable year of the organization. Either of the following facts, although not conclusive, may indicate the requisite intent:
(A) At the time of the formation of the organization, the members agree that the organization shall be excluded from subchapter K beginning with the first taxable year of the organization; or
(B) The members of the organization owning substantially all of the capital interests report their respective shares of income, deductions, and credits from the organization on their respective income tax returns, making such elections as to individual items as may be appropriate, in a manner consistent with the exclusion of the organization from subchapter K beginning with the first taxable year of the organization.

(5) Effect of election. An election to be excluded from subchapter K shall be effective, unless within ninety days after the formation of the organization, any member of the organization notifies the director of taxation that the member desires subchapter K to apply to the organization, and also advises the director that all other members of the organization have been notified of the change by registered or certified mail. As long as the organization remains qualified under section 761(a), IRC, the election is irrevocable. Application for permission to invoke the election must be submitted to the director.

(6) When to file. Partnership returns, including returns filed by unincorporated organizations electing to be excluded from subchapter K, shall be filed on or before the twentieth day of the fourth month following the close of the taxable year of the partnership. The return shall be made on the form as prescribed by the department, and shall be for the taxable year of the partnership or unincorporated organization, irrespective of the partners' taxable years.

(7) Where to file. Partnership returns shall be filed with the director of taxation or designee in the district in which the principal place of business is located, or if the organization has no principal place of business in the State, then the return shall be filed with the director in Honolulu.

(8) Accounting period. Where an organization, as described in federal Treasury Regulation section 1.761-2(a), has not adopted an accounting period, the organization's taxable year shall be the calendar year as set forth in section 441(g), IRC.

(b) Partnerships having no business in the State.

(1) No partnership return required. A partnership carrying on no business in the State and deriving no income from sources within the State need not file a partnership return. However, even where a partnership has no business in the State and derives no income from sources within the State, if a resident partner receives distributions from the partnership subject to taxation under chapter 235, HRS, the partnership shall file a partnership return with the department unless the partnership elects to be excluded from subchapter K. A return of information filed by a resident partner shall constitute a filing by the partnership.

(2) Returns required of resident partners. Pursuant to section 235-4, HRS, all resident partners shall report all taxable income derived from any partnership and unincorporated organization excluded from subchapter K, irrespective of whether the partnership or organization is required to file a partnership return. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-95)

HRS §235-96 §18-235-96 **Returns by persons making payments.** (a) Return of information; payments of $600 or more.

(1) General rule. Except as provided in subsection (c), every person engaged in a trade or business in Hawaii or having a place of business in Hawaii shall make an information return for the calendar year with respect to payments made by the taxpayer during the year in the course of the taxpayer's trade or business to another person, of fixed or determinable:

(A) Salaries, wages, commissions, fees, and other forms of compensation for services rendered aggregating $600 or more;

(B) Interest, rents, royalties, annuities, pensions, and other gains, profits, and income aggregating $600 or more, except as provided in subsection (h); or

(C) Foreign items, as defined in this subsection, aggregating $600 or more.

The return required by this paragraph shall be made on federal Form 1099 or on forms as prescribed by the department. Transmittal Form N-196 shall accompany all submissions of federal Form 1099 or other information returns required under this section on forms as prescribed by the department. A separate return of information shall be furnished for each person to whom payments of $600 or more are made.

(2) Definitions. As used in this section:

"Persons engaged in a trade or business" includes not only those persons engaged in a trade or business for gain or profit, but also organizations exempt from income tax, as set forth in section 235-9, HRS, and in paragraph (7). These rules apply only to payments made in the course of trade or business; hence, payments made by a person outside the course of a trade or business, such as payments made for personal expenses, are excluded.

"Fixed or determinable income" means income which is fixed as to when it is paid, and the amounts are definite and predeterminable. Income is determinable whenever there is a basis of calculation by which the payment amount may be ascertained and need not be paid annually or at regular intervals. For these purposes, the fact that the payments may be increased or decreased in accordance with the trade or business activity, such as payments made to a salesperson who is paid on a commission basis, does not make the payments any less determinable.

"Foreign item" means any interest derived from the bonds of a foreign country or of a nonresident corporation, organized and existing under the laws of a foreign country, not having a fiscal agent or paying agent in Hawaii, or any dividends upon stock of such corporation.

"Domestic corporation", "foreign corporation", "resident estate", and "resident trust" shall be defined as set forth in section 235-1, HRS.

(3) Types of payments included. Payments which must be reported pursuant to this rule, include:

(A) Sums paid in respect of life insurance, endowment, or annuity contracts unless:

(i) The payment is made in respect of a life insurance or endowment contract upon the death of the insured and is not required to be reported by these rules;

(ii) The payment is made upon surrender or lapse of a policy which was purchased and paid for by the insured; or

(iii) The payment is made in the form of a pension for past services performed and which qualifies for exclusion from gross income under section 235-7, HRS, and this rule.

(B) Fees paid to attorneys, physicians, and members of other professions for professional services rendered if the fees are paid by persons engaged in the course of a trade or business.

(C) The fair market value of prizes and awards which are includable in gross income under section 74, IRC, when paid in the course of a trade or business.

(4) Payment in property other than cash. If any payment required to be reported under this section is made in property other than cash, the fair market value of the property at the time of payment shall be the amount reported on the return of information.

(5) When payment deemed made. For reporting purposes, an amount is deemed paid when it is credited or set apart for the recipient without any substantial limitation or restriction as to the time, manner, or condition upon which payment is to be made. The recipient must be able to draw on the payment at any time, and retain control and disposition over the payment.

(6) Payments made by State or any political subdivision thereof. Informational returns on payments made by the State or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing, shall be filed by the officer or employee

of the State or political subdivision, or of such agency or instrumentality having control over the payments or the officer or employee designated to make the return.

(b) Return of information; payments to employees.

(1) In general. Wages, as defined in section 235-61, HRS, of $600 or more paid to an employee shall be reported on Form HW-2. Payments made in property other than cash of $600 or more shall be reported on federal Form 1099 or on forms prescribed by the department. Where a total of $600 or more is paid to an employee and the payment consists of wages and property other than cash, the wages shall be reported on Form HW-2 and the cash value of the property shall be reported on federal Form 1099 or on forms prescribed by the department. Where property other than cash is received by an employee in the course of a trade or business, the cash value of the property received (except for items excludable from gross income such as meals and lodging furnished for the convenience of the employer, or that which is excludable under section 235-7, HRS) shall be reported on federal Form 1099 or on forms prescribed by the department. For example, if a payment of $700 was made to an employee and $400 represents wages subject to withholding under section 235-61, HRS, and the remaining $300 represents compensation not subject to withholding, the $400 must be reported on Form HW-2 and the $300 must be reported on federal Form 1099 or on forms prescribed by the department.

(2) Distribution under employees' trust and annuity plans. In general, pursuant to section 235-7, HRS, and section 18-235-7, distributions to a beneficiary under a stock bonus, pension, profit-sharing, or annuity plan are not subject to state income taxation. Those portions of the distributions which are attributable to employee contributions, however, shall be included in the beneficiary's gross income if the distributions to the beneficiary are $600 or more for the calendar year. The distributions shall be reported on federal Form 1099 or on forms prescribed by the department.

(c) Payments for which no return of information is required. Payments of the following character need not be reported on information returns to the department:

(1) Payments of income required to be reported on Forms HW-14, HW-2, and HW-3;

(2) Payments by a broker or by the broker's customer;

(3) Payments of any type made to corporations (except payments made by corporations organized under chapter 421, HRS, to their members which are corporations);

(4) Payments of bills for merchandise, telegrams, telephone, freight, storage, and similar charges;

(5) Payments of rent made to real estate agents (but the agent is subject to the requirements under subsection (a)(1)(B));

(6) Payments representing earned income for personal services rendered outside the State, made to an individual who is a nonresident, as defined in section 235-1, HRS;

(7) Payments representing earned income for personal services rendered outside the State, made to an individual who takes up residence in Hawaii after attaining the age of sixty-five years prior to July 1, 1976;

(8) Salaries and profits paid or distributed by a partnership to the individual partners;

(9) Payments of commissions to general agents of fire insurance companies or other companies insuring property, unless the general agents are the actual payers of the commission, then payments are subject to the requirements under subsection (a)(1)(B);

(10) Any advances, reimbursements, or charges for traveling and other business expenses of an employee which are submitted to an employer in a written statement, identifying the type and amount of the expense;

(11) Amounts paid as an allowance or reimbursement for traveling or other bona fide ordinary and necessary expenses, including an allowance for meals and lodging or a per diem allowance in lieu of subsistence, as set forth in federal Treasury Regulation 1.6041-3(m); or

(12) Payments of interest coupons payable to bearer.

(d) Returns of information; foreign items. If $600 or more of foreign items, as defined in subsection (a) is paid in any calendar year to an individual who is a resident of Hawaii, to a fiduciary of a resident estate or resident trust (as defined in section 235-1, HRS) or to a resident partnership (any member of which is a resident of Hawaii) an information return shall be filed on federal Form 1099 or on forms prescribed by the department, setting forth the amount of such items. The forms shall be filed by any person who accepts the item for collection as a matter of business or for profit, such as a bank as defined in section 241-1, HRS.

As used in this subsection, "collection" includes: (1) payment of the foreign item in cash; (2) the crediting of the account of the person presenting the foreign item; or (3) the tentative crediting of the account of the

person presenting the foreign item until the amount of the foreign item is received by the bank or collecting agent from abroad for the purpose of transmitting them abroad for deposits.

(e) Information as to actual owner. When a person receiving a payment, subject to the reporting requirements of this section, is not the actual owner of the income received, the name and address of the actual owner shall be furnished upon demand of the person paying the income. In default of compliance with such demand, the payee becomes liable for the penalties provided in section 235-105(c), HRS.

(f) Time and place for filing; information to be reported. Forms required to be filed and information to be reported under this section for any calendar year shall be filed on or before February 28 of the following year with the director of taxation or designee for the taxation district in which the payer's principal place of business is located. The name and address of the person making the payment and the name and address of the recipient of the payment shall be stated on federal Form 1099 or on forms prescribed by the department.

(g) Return of information; payments of dividends.

(1) Filing requirement of return. Every domestic corporation (including cooperative associations organized under chapter 421, HRS, any association subject to chapter 407, HRS, or a bank as defined in section 241-1, HRS) or foreign corporation engaged in a trade or business within Hawaii, having an office or place of business, or a fiscal or paying agent in Hawaii, and which pays dividends or makes distributions of $10 or more during the calendar year (other than distributions in liquidation), to any shareholder who is an individual resident of Hawaii, a fiduciary of a resident estate or resident trust, or to a resident partnership (any member of which is a resident of Hawaii), shall file an information return for the calendar year setting forth the amount of such payments for the calendar year. A separate return of information shall be filed on federal Form 1099 or on forms as prescribed by the department for each shareholder, showing the name and address of the payer and the shareholder, and the amount paid. These returns shall be accompanied by a transmittal form as prescribed by the department.

(2) Nontaxable or partly nontaxable distributions. In the case of a distribution which is made from a depletion or depreciation reserve, or which is deemed by the corporation to be nontaxable or partly nontaxable to its shareholders, the corporation shall report the information on forms as prescribed by the department.

(3) Information as to actual owners.

(A) In general. When the person receiving a payment is not the actual owner of the income received, the name and address of the actual owner or payee shall be furnished upon demand of the person paying the income. In default of compliance with such demand, the payee becomes liable for the penalties provided in section 235-105(c), HRS. Dividends on stock are the income of the record owner of the stock. If a record owner of stock, who is not the actual owner, receives dividends on such stock, the record owner shall disclose the name and address of the actual owner or payee, the name of the issuing corporation, the number of shares of stock held by the actual owner or payee, and the amount of dividends received with respect to such stock during the calendar year to the department of taxation. Unless disclosure of the information is made, the record owner will be held liable for any tax assessed against the dividends. A separate form shall be filed by the record owner for each of the stockholdings of each actual owner for whom the record holder acts as nominee. However, where the record owner is a banking institution, trust company, or brokerage firm engaged in such trade or business in Hawaii or having a place of business in Hawaii, provided it maintains such records as will permit a prompt substantiation of each payment of dividends made to the actual owner, it may file the prescribed forms for each actual owner for whom it acts as nominee and report thereon the amount of dividends paid to the actual owner (without itemization as to the issuing company, class of stock, etc.).

(B) Exceptions. The filing of information returns under this subsection is not required if:

(i) The record owner is required to file a fiduciary return on Form N-40;

(ii) The actual owner or payee is a nonresident individual, or is a partnership not engaged in a trade or business in Hawaii, or does not have a place of business in Hawaii;

(iii) The record owner is a banking institution, a trust company, or a brokerage firm which prepares the individual income tax return of the actual owner, provided the record owner verifies the preparation of the income tax return;

(iv) The record owner is a nominee of a banking institution or trust company exercising trust powers, and the banking institution or trust company is required

to file a fiduciary return on Form N-40 which reflects the name and address of the actual owner or payee;

(v) The actual owner is an organization exempt from taxation under chapter 235, HRS; or

(vi) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under chapter 235, HRS.

(4) Time and place for filing returns. Forms required to be filed and information to be reported under this section, for any calendar year, shall be filed on or before February 28 of the following year with the director of taxation or designee for the taxation district in which the payer's principal place of business is located.

(h) Return of information as to certain payments of interest. As provided in section 6049, IRC, and the regulations thereunder, returns shall be filed by the payer of interest totaling $10 or more.

(i) Substitute forms. For purposes of this section, returns of information may be reported on federal Form 1099 or on forms prescribed by the department. Only commercially printed substitutes or other forms which comply with the requirements of the Internal Revenue Service may be substituted for federal Form 1099.

(j) Penalties for failure to file information returns. Every person who fails to file the information returns as required by section 235-96, HRS, and this section, shall be liable for the penalties provided in section 235-105(c), HRS. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-96, 235-118) (Imp: HRS §235-96)

§18-235-96.5 (Reserved)

HRS §235-97 **§18-235-97** **Estimates; tax payments; returns.** (a) Definitions. For purposes of this section:

"Tax" shall be defined as set forth in section 235-97, HRS.

"Taxpayer" means individuals, corporations (including corporations organized under subchapter S of the Internal Revenue Code of 1986), estates, and trusts, except where the taxpayer clearly refers to only one of the preceding.

(b) Filing of estimated tax.

(1) In general. In general, every taxpayer (including S corporations), subject to taxation under chapter 235, HRS, shall submit estimated tax payments on a quarterly basis to the department. The estimated tax payments shall be accompanied by forms prescribed by the department. As provided in section 235-97(a)(2), HRS, where tax is withheld from wages or collected at the source, the amount of tax withheld or collected at the source shall be deducted from the total estimated tax liability of the taxpayer for the taxable year.

(2) Exceptions. Estimated tax payments are not required if:

(A) The taxpayer's estimated tax liability (after taking into account all taxes withheld or collected at the source) for the taxable year is less than $500;

Example: R, a single individual, is employed as a carpenter. In 1993, R expects to earn $30,000 from which $2,300 in taxes will be withheld. During 1993, R also expects to earn $2,500 for carpentry performed for family and friends; no tax will be withheld.

Based on an estimated gross income of $32,500, less the standard deduction of $1,500 and personal exemption of $1,040, R's estimated taxable income is $29,960. R's estimated tax liability is $2,535.

Since the difference between R's estimated tax liability and the amount of tax withheld from R's salary is less than $500, R is not required to submit estimated tax for 1993.

(B) The taxpayer did not have any tax liability for the preceding taxable year; or

(C) Pursuant to section 235-97(a)(6), HRS, the taxpayer is a foreign corporation which, under sections 235-21 to 235-39 or other provisions of chapter 235, HRS, attributes less than fifteen per cent of the foreign corporation's business (entire gross income computed without regard to source) for the taxable year to the State.

(3) Exemption for foreign corporation. If a foreign corporation is not required to submit estimated tax pursuant to section 235-97, HRS, and this section, the corporation shall apply for an exemption. The corporation shall submit two copies of a letter requesting an exemption from the payment of estimated tax under section 235-97(a)(6), HRS, to the department. Income tax returns from the preceding year, as well as other pertinent information, may be submitted along with the letter in support of the corporation's claim for exemption. A copy of the letter, stating whether the exemption is granted or denied,

shall be returned to the taxpayer. If, after an exemption is issued, a foreign corporation's business activity (actual or expected) in the State increases, and the foreign corporation no longer qualifies for the exemption from section 235-97, HRS, the exemption from making estimated tax payments is automatically terminated. Upon termination, the corporation is required to submit estimated tax to the department pursuant to section 235-97, HRS, and this section.

(c) Method of estimating tax liability; payment of estimated tax.

(1) Method of estimating tax liability. In order to determine whether a taxpayer is required to make quarterly estimated tax payments, as provided in section 235-97, HRS, and this section, the taxpayer shall calculate the taxpayer's estimated tax liability for the taxable year. The taxpayer's estimated tax liability is calculated as follows:

(A) Determine the taxpayer's estimated taxable income for the taxable year. The taxpayer's estimated taxable income is the taxpayer's anticipated gross income minus any reasonably expected deductions, including personal exemptions and the standard deduction.

(B) Calculate the taxpayer's estimated tax liability. Based on the taxpayer's estimated taxable income, calculate the taxpayer's estimated tax liability for the taxable year using: the tax schedules set forth in section 235-51(a) to (c), HRS, for individuals; the tax schedule set forth in section 235-51(d), HRS, for estates and trusts; or the tax rates set forth in section 235-71, HRS, for corporations. Tax tables prescribed under section 235-53, HRS, may be used if appropriate.

(C) Subtract any tax credits. Tax withheld from wages or collected at the source, or any overpayment from the immediately preceding year which the taxpayer elects to have applied against the current taxable year's tax liability shall be subtracted from the taxpayer's estimated tax liability as provided in this subsection. In addition, any estimated tax payments already made by the taxpayer for the current taxable year shall be subtracted from the taxpayer's estimated tax liability.

If the taxpayer elects to have the preceding year's income tax overpayment credited to the current year's estimated tax liability, the taxpayer may allocate the overpayment amount either: to the first estimated tax payment, with any balance allocated to each successive quarterly payment until the overpayment amount is exhausted; or ratably allocate the overpayment amount to all estimated tax payments for the current taxable year.

If, after any available tax credit is subtracted from the estimated tax liability, the taxpayer's estimated tax liability is $500 or more, the taxpayer shall submit estimated tax payments on a quarterly basis pursuant to section 235-97, HRS, and this section.

(2) Change in application of overpayment; request for refund. In general, once a taxpayer elects to apply an overpayment to the current year's estimated tax liability or elects to receive a refund of the overpayment, the taxpayer may not revoke the election without first receiving permission from the director or designee. A request to change the application of the overpayment or request for a refund shall be made by submitting a letter to the department.

(3) Deficiency and assessment. Pursuant to section 235-108, HRS, a taxpayer's return is subject to determination and assessment regardless of whether credit is taken for an overpayment of income tax from the immediately preceding taxable year. The allocation of a credit to the current year's estimated tax liability based on the overpayment amount does not preclude the finding of a deficiency for the taxable year in which the overpayment occurred. Moreover, if a taxpayer underpays any estimated tax payment, an addition to tax shall be added to the taxpayer's tax liability for the taxable year as provided in section 235-97(f), HRS.

(4) Dispute over tax liability. If a taxpayer protests the validity of any provision of the law, rules, or instructions relating to the filing and submission of the taxpayer's income tax return, the taxpayer may not elect to allocate any overpayment amount to the estimated tax liability for the subsequent taxable year. The taxpayer must apply for a refund. If the taxpayer's income tax protest is not allowed by the director, an assessment for the taxable years at issue will first be made by the director. Any overpayment, if not previously refunded, shall be applied against the assessment. The assessment shall be subject to review and the amount involved subject to repayment to the taxpayer as provided by chapter 231, HRS.

(d) Joint or separate filing of estimated tax by married taxpayers.

(1) In general. A husband and wife may file estimated tax returns jointly even though they are not living together. However, a joint filing may not be made if the spouses are legally

separated under a decree of divorce or of separate maintenance; one of the spouses is a nonresident alien, except as allowed under section 18-235-93; or the spouses have different taxable years.

(A) Filing of estimated tax by married taxpayers. Married taxpayers may file estimated tax either separately or jointly, even if only one spouse has estimated tax liability; provided that if married taxpayers choose to file estimated tax separately, the spouses must both elect to either itemize their nonbusiness deductions or use the standard deduction in calculating their estimated tax liability.

(B) Personal exemptions; married taxpayers filing estimated tax returns separately. For purposes of determining a taxpayer's separate estimated tax liability, the tax liability must be estimated without taking into consideration the exemptions of the taxpayer's spouse, unless the taxpayer's spouse has no gross income and is not claimed as a dependent of another taxpayer.

Exemptions claimed for any children may only be claimed by the spouse who is qualified to claim the children as dependents, as provided in chapter 235, HRS. Where both spouses are qualified to claim the children as dependents, the spouses may agree as to which spouse may claim the children as dependents, or the spouses may equally divide the number of exemptions available; provided that the exemptions are not divided into fractional shares.

(C) Joint filing of estimated tax; consent to disclosure. The joint filing of an estimated tax return constitutes a consent by both spouses, that if payments of estimated tax are allocated pursuant to this rule, the amount of tax shown on the joint estimated tax return may be made known to the other spouse.

(2) Payment of estimated tax filing of income tax returns. If married taxpayers file estimated tax returns separately, they shall not be precluded from filing a joint income tax return for the taxable year. If married taxpayers file their estimated tax return jointly, they shall not be precluded from filing separate income tax returns for the taxable year.

In the case where a husband and wife jointly file their estimated tax return, but do not choose to file a joint income tax return for the same taxable year, the estimated tax payments made for the taxable year may be credited against the tax liability of either the husband or wife, or may be divided between them in such manner as they may agree. If a husband and wife fail to agree to a division of the estimated tax payments, the payments shall be allocated between them as follows: the portion of the estimated tax payments to be allocated to each spouse shall be based on the proportionate share each spouse's tax liability bears to the combined tax liability of the spouses.

(3) Death of spouse.

(A) Joint filing of estimated tax. A joint filing of an estimated tax return may not be made after the death of a spouse. However, if it is reasonable for a surviving spouse to assume that a joint income tax return will be filed for the last taxable year of the deceased spouse, the surviving spouse may, if needed, make a separate filing of estimated tax for the taxable year in which the deceased spouse died. The surviving spouse may calculate taxable income on the aggregate taxable income of both spouses and the estimated tax liability may be computed as though estimated tax is filed jointly.

If an estimated tax return is filed jointly by a husband and wife and thereafter one spouse dies, no further payments of estimated tax are required from the estate of the decedent for the period ending on the date of the decedent's death. The surviving spouse shall remain liable for any subsequent payments of estimated tax; the surviving spouse, however, may amend the filing and choose to report the estimated tax for the taxable year separately.

If the surviving spouse chooses to file separately, the estimated tax shall be computed on the aggregate taxable income of both the surviving spouse and the deceased spouse; provided the surviving spouse files a joint income tax return for the deceased spouse's last taxable year.

(B) Amendment of the estimated tax filing. If a surviving spouse chooses to amend the estimated tax filing upon the death of a spouse, payments made pursuant to a joint filing by the spouses may be divided between the decedent and the surviving spouse in such proportion as the surviving spouse and the legal representative of the decedent may agree. If the surviving spouse and the legal representative of the decedent fail to agree to a division of the payments, the payments shall be allocated as follows: the

portion of the estimated tax payments to be allocated to each spouse shall be based on the proportionate share each spouse's tax liability bears to the total tax liability of both spouses. Any overpayment made pursuant to the joint filing shall be allocated based on the taxpayer's proportionate share of the tax liability.

(e) Time and place for filing estimated tax forms; payment of estimated tax liability.

(1) Filing dates. The dates for filing the estimated tax returns prescribed by the department and for payment of the estimated tax are as follows:

(A) Calendar year basis taxpayer. Unless a taxpayer chooses to submit the taxpayer's estimated tax liability in full at the time the first payment is due, estimated tax shall be made in four equal payments: one payment on or before April 20; one payment on or before June 20; one payment on or before September 20; and one payment on or before January 20 following the close of the taxable year.

(B) Fiscal year basis taxpayers. Unless a taxpayer chooses to pay the taxpayer's estimated tax liability in full at the time the first payment is made, a fiscal year basis taxpayer shall file estimated tax on a schedule similar to a calendar year taxpayer. Fiscal year taxpayers shall make the first payment of estimated tax for the current taxable year on or before the twentieth day of the fourth month of the taxpayer's fiscal year. Thereafter, the remaining estimated tax payments shall be made on or before the twentieth day of the sixth and ninth months of the fiscal year, and the twentieth day of the first month following the close of the fiscal year.

(2) Change of circumstances. If, after the due date for filing the first payment of estimated tax (April 20 for calendar year taxpayers, and the twentieth day of the fourth month for fiscal year taxpayers), a taxpayer who previously had not been required to file estimated tax is required to file estimated tax due to changed financial circumstances, the taxpayer shall file estimated tax on or before the next payment date.

(A) Calendar year basis taxpayers. If the change in the taxpayer's financial circumstances which necessitates the filing of estimated tax returns occurs after March 31 but before June 1, estimated tax shall be submitted to the department in three equal payments. The first payment shall be submitted on or before June 20; the second payment shall be submitted on or before September 20; and the third payment shall be submitted on or before January 20 following the close of the calendar year.

If the change in the taxpayer's financial circumstances which necessitates the filing of estimated tax returns occurs after May 31 but before September 1, estimated tax shall be submitted to the department in two equal payments. The first payment shall be submitted on or before September 20, and the second payment shall be submitted on or before January 20 following the close of the calendar year.

If, however, the change in the taxpayer's financial circumstances which necessitates the filing of estimated tax returns, occurs after August 31, the taxpayer may either: file an estimated tax return on or before January 20 following the close of the calendar year; or file the income tax return and submit any tax owed for the taxable year by January 31 following the close of the taxable year.

(B) Fiscal year basis taxpayers. If the change in the taxpayer's financial circumstances which necessitates the filing of estimated tax returns occurs after the last day of the third month but before the first day of the sixth month of the taxpayer's fiscal year, estimated tax shall be submitted to the department in three equal payments. The first payment shall be submitted on or before the twentieth day of the sixth month; the second payment shall be submitted on or before the twentieth day of the ninth month; and the third payment shall be submitted on or before the twentieth day of the first month following the close of the fiscal year.

If the change in the taxpayer's financial circumstances which necessitates the filing of estimated tax returns occurs after the last day of the fifth month but before the first day of the ninth month of the fiscal year, estimated tax shall be submitted to the department in two equal payments. The first payment shall be submitted on or before the twentieth day of the ninth month; and the second payment shall be submitted on or before the twentieth day of the first month following the close of the fiscal year.

If, however, the change in the taxpayer's financial circumstances which necessitates the filing of estimated tax returns occurs after the last day of the eighth month of the fiscal year, the taxpayer may either: file an estimated tax return on or before the twentieth day of the first month following the close of the fiscal year; or file the

income tax return and submit any tax owed for the taxable year by the last day of the first month following the close of the fiscal year.

(3) Place for filing estimated tax return; payment of estimated tax. Estimated tax returns as prescribed by the department and all estimated tax payments shall be filed with the director or designee in the taxation district in which the taxpayer expects to file an income tax return for the taxable year.

(f) Death of taxpayer. If an individual taxpayer dies during the taxable year, additional payments of estimated tax with respect to that taxable year are not required by the taxpayer's estate subsequent to the date of death.

(g) Payment of estimated tax in advance. At the election of the taxpayer, any payment of estimated tax may be made prior to the prescribed due date.

(h) Amendment of the estimated tax calculation; change in payment amount.

(1) Pursuant to section 235-97(e), HRS, a taxpayer may recalculate the taxpayer's estimated tax liability. If a taxpayer's financial circumstances change such that it requires the taxpayer to either increase or decrease the amount of the taxpayer's estimated tax payments, the taxpayer shall recalculate the taxpayer's estimated tax liability for the taxable year. The recomputed tax liability then shall be reduced by any estimated tax payments already made for the taxable year. The balance of the estimated tax liability owed for the taxable year shall be divided equally among the remaining quarterly payment periods; the payments shall be ratably increased or decreased to reflect the estimated increase or decrease in the estimated tax liability. If an amendment is made after September 20 for calendar year taxpayers, or after the twentieth day of the ninth month of the fiscal year for fiscal year taxpayers, any increase in the estimated tax liability shall be paid at the time the amendment is made.

(2) Filing income tax return on or before January 31; individuals. If an individual calendar year taxpayer files an income tax return for the taxable year on or before January 31 following the close of the taxable year (or on or before the last day of the first month following the close of the fiscal year for fiscal year taxpayers), and the individual taxpayer pays any tax liability owed on the return in full, then the individual taxpayer shall not be assessed any addition to tax with respect to any underpayment of the fourth quarter estimated tax payment of the taxable year. The filing of the income tax return on or before January 31 (or on or before the last day of the first month following the close of the fiscal year for fiscal taxpayers) shall be considered the individual taxpayer's fourth quarter estimated tax filing.

(i) Filing estimated tax form; short taxable years.

(1) In general. For purposes of this subsection, federal Treasury Regulations sections 1.6654-3 and 1.6655-3 (regarding short taxable years), shall apply. An estimated tax form and payment for a short taxable year shall be filed if, with the approval of the director, there is a change in the taxpayer's accounting period from one taxable year to another, resulting in a short taxable year.

The filing of an estimated tax form, however, is not required if the short taxable year is:

(A) A period of less than four months; or

(B) A period of less than six months, and the circumstances necessitating the filing of estimated tax returns first occur after the first day of the fourth month; or

(C) A period of less than nine months, and the circumstances necessitating the filing of estimated tax returns first occur after the first day of the sixth month; or

(D) A period of nine months or more and the circumstances necessitating the filing of estimated tax returns first occur after the first day of the ninth month.

(2) Time for filing estimated tax return and payment of estimated tax. The filing of the estimated tax return and payment of estimated tax for a short taxable year shall follow the same schedule as for a full twelve month calendar or fiscal year as set forth in subsection (e); except that in no event shall the payment of estimated tax in full be later than the twentieth day of the first month following the close the short taxable year. The number of payments for a short taxable year shall be determined as follows:

(A) Determine the number of payment dates which occur in the short taxable year (i.e., the twentieth day of the fourth, sixth and ninth months, if any, of the short taxable year, or any payment dates which occur after any change in circumstances which necessitate the filing of estimated tax; and

(B) Add, as another payment date, the twentieth day of the first month of the taxable year following the close of the short taxable year.

In order to calculate the amount of each payment, the taxpayer should divide the total estimated tax liability for the short taxable year by the number of payment dates.

(3) Use of annual basis. In the case of a short taxable year, for the purpose of determining whether the taxpayer is required to submit an estimated tax return and estimated tax, the taxpayer's income shall be calculated on an annual basis.

(j) Addition to tax related to underpayment of estimated tax. The director of taxation may waive any addition to tax related to the underpayment of estimated tax pursuant to section 235-97(f)(4), HRS, and as set forth in section 6654(e)(3) of the Internal Revenue Code of 1986. [Eff 2/16/82; am 1/1/94; am 10/13/94] (Auth: HRS §§231-3(9), 235-97(a), 235-118) (Imp: HRS §235-97)

HRS §235-98 **§18-235-98 Returns; form, verification and authentication, time of filing.** (a) Extensions of time for filing income tax returns; in general. The director of taxation may grant a reasonable extension of time for filing any return, declaration, statement, or other document required under chapter 235, HRS, provided that no extension shall be for more than six months, except as otherwise provided by statute for cases in which exceptional circumstances require additional time, including cases of persons who are outside the United States.

(b) An extension only applies to the requesting taxpayer. Unless otherwise stated in the statutes, these rules, or the extension itself, an extension to file a return only applies to the taxpayer who submitted the application. For example, an extension of time for filing a partnership, estate, trust, or real estate mortgage investment conduit return or other document does not operate to extend the time for filing a return or other document for, as the case may be, any partner, or member of an entity classified as a partnership, any beneficiary of the estate or trust, or a residual or regular interest holder of a real estate mortgage investment conduit

(c) Automatic extension of time for filing individual income tax return. Any individual taxpayer required to file an income tax return, declaration, statement, or other document under chapter 235, HRS, is granted an automatic six-month extension to file the tax return after the date prescribed for filing. The taxpayer need not file an application form to request an extension. However, if the taxpayer makes a payment of tax, the payment shall be submitted with the form prescribed by the department. No signature is required on the application. Automatic extensions for individual taxpayers shall be granted subject to the following conditions:

(1) On or before the due date prescribed by the statute for the filing of a return, there shall have been paid, through estimated tax payments or a payment accompanying an application for the extension, an amount equal to the properly estimated tax liability for the taxable year;

(2) The tax return shall be filed within the time granted by the automatic extension and shall be accompanied by payment of tax shown as due on the return to the extent not already paid; and

(3) The taxpayer is not bound by a court order to file the tax return, declaration, statement, or other document to be extended on or before the prescribed due date.

The failure to file a tax return penalty under section 231-39(b)(1), HRS, shall not be imposed on any return filed on or before the extended due date if these conditions are met. However, if the stated conditions are not met, the automatic extension shall be deemed invalid and penalties and interest shall be assessed on the amount of tax owed as if no automatic extension had been granted (i.e., the computation of penalties under section 231-39(b)(1), HRS, and interest under section 231-39(b)(4), HRS, shall relate back to the due date prescribed by the statute).

(d) Automatic extensions for partnerships, estates, trusts, or real estate mortgage investment conduits. A partnership or entity classified as a partnership, estate, trust, or real estate mortgage investment conduit may obtain an automatic six-month extension. An application for an automatic extension on the form prescribed by the department must be filed on or before the date prescribed for the filing of the return. No signature is required on the application. Automatic extensions for partnerships, estates, trusts, or real estate mortgage investment conduits shall be granted subject to the following conditions:

(1) On or before the due date prescribed by the statute for the filing of a return, there shall have been paid, through estimated tax payments or a payment accompanying the application for the extension, an amount equal to the properly estimated tax liability for the taxable year. If a payment accompanies the application for the extension, the amount of the payment shall be shown on the application;

(2) The tax return shall be filed within the time specified by the automatic extension and shall be accompanied by payment of the tax shown as due on the return to the extent not already paid; and

(3) The taxpayer is not bound by a court order to file a tax return, declaration, statement, or other document to be extended on or before the prescribed due date.

The failure to file a tax return penalty under section 231-39(b)(1), HRS, shall not be imposed on any return filed on or before the extended due date if these conditions are met. However, if the stated conditions are not met, the automatic extension shall be deemed invalid and penalties and interest shall be assessed on the amount of

tax owed as if no extension had been granted (i.e., the computation of penalties under section 231-39(b)(1), HRS, and interest under section 231-39(b)(4), HRS, shall relate back to the due date prescribed by the statute).

(e) Automatic extension of time for filing corporate income tax returns or corporate income tax returns for entities classified as a corporation.

(1) In general. A corporation or entity classified as a corporation shall be allowed an automatic six-month extension of time to file its income tax return, declaration, statement, or other document. An application for an automatic extension on the form prescribed by the department must be filed on or before the date prescribed for the filing of the return. No signature is required on the application. Automatic extensions for corporations shall be granted subject to the following conditions:

(A) On or before the due date of the return prescribed by the statute, there shall have been paid, through estimated tax payments or a payment accompanying the application for the extension, an amount equal to the properly estimated tax liability for the taxable year. If a payment accompanies the application for the extension, the amount of the payment shall be shown on the application;

(B) The income tax return shall be filed within the time specified by the automatic extension and shall be accompanied by payment of the tax shown as due on the return to the extent not already paid; and

(C) The taxpayer is not bound by a court order to file a tax return, declaration, statement, or other document to be extended on or before the prescribed due date.

The failure to file a tax return penalty under section 231-39(b)(1), HRS, shall not be imposed on any return filed on or before the extended due date if these conditions are met. However, if the stated conditions are not met, the automatic extension shall be deemed invalid and penalties and interest shall be assessed on the amount of tax owed as if no extension had been granted (i.e., the computation of penalties under section 231-39(b)(1), HRS, and interest under section 231-39(b)(4), HRS, shall relate back to the due date prescribed by the statute).

(2) Consolidated returns. If a consolidated return is to be filed under section 235-92(2), HRS, a parent corporation or parent entity classified as a corporation may request an automatic extension for its subsidiaries. In this case, the name, address, and employer identification number of each member of the affiliated group, for which the extension is desired, must be listed. The filing of an application for extension of time by a parent corporation or parent entity classified as a corporation is not considered an exercise of the privilege of filing a consolidated return. If the privilege of filing a consolidated return is not exercised, the parent corporation or parent entity classified as a corporation and members of the affiliated group shall attach a copy of the application for extension to their completed separate income tax returns.

(f) Termination. The director of taxation may terminate the automatic extension at any time by mailing a notice of termination to the taxpayer. In the case of a corporation or entity classified as a corporation, notice of termination shall be mailed to the corporation or entity classified as a corporation, or to the person who requested the extension for the corporation. The notice shall be mailed at least ten days prior to the termination date designated in the notice.

(g) Properly estimated tax liability; safe harbor. For purposes of this section, "properly estimated tax liability" means the taxpayer made a bona fide and reasonable attempt at the time the extension was submitted to locate and gather all of the necessary information to make a proper estimate of tax liability for the taxable year. Payment of properly estimated tax liability will be presumed if the tax still owing after the due date prescribed by the statute for the filing of a return (determined without regard to any extension) is 10 percent or less of the total tax shown as due on the return.

(h) Time for payment of tax not extended by extensions. Any extension to file an income tax return under section 235-98, HRS, shall not extend the time for payment of any tax due on the return, but shall only extend the time to file the return. Interest under section 231-39(b)(4), HRS, shall be assessed on any amount of tax that is not paid on or before the prescribed due date. [Eff 2/16/82; am 6/28/93; 1/1/94; 10/13/94; 1/5/98; am 6/4/05; am 10/06/07] (Auth: HRS §§231-3(9), 231-39, 235-98, 235-118) (Imp: HRS §§231-39 and 235-98)

HRS §235-99 **§18-235-99 Place and time of filing returns.** (a) In general. An individual taxpayer's income tax return for the taxable year shall be filed with the director of taxation or designee in the taxation district in which the taxpayer's residence or principal place of business is located, or if the individual has no residence or place of business in the State, then the return shall be filed with the director of taxation in Honolulu.

(b) Due date. Unless the due date for filing is extended, the return shall be filed on or before the twentieth day of the fourth month following the close of the taxable year. The return shall be accompanied by payment

of the balance of the tax due, after applying credits allowable under chapter 235, HRS, and after deducting payments of estimated tax for the taxable year, if any. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-99)

§18-235-100 to 18-235-101 (Reserved)

HRS §235-102 **§18-235-102 Records and special returns.** (a) In general. Except as provided in subsection (b) any person subject to tax under chapter 235, HRS, or any person required to file a return of information with respect to income, shall keep such permanent books of account or records, including inventories, as are sufficient to establish the amount of gross income, deductions, credits, or other matters required to be reported in any income tax return or return information. The records shall be kept in the English language and shall be made available upon request by the director or designee.

(b) Wage earners. Individuals whose gross income includes salaries, wages, or similar compensation for personal services rendered are required to keep records which will enable the director of taxation to determine the correct amount of income subject to tax. It is not necessary, however, that with respect to the income discussed in this subsection that individuals keep the books of account or records required by subsection (a).

(c) Exempt organizations. In addition to such permanent books and records as required by subsection (a), with respect to the tax imposed on unrelated business income under section 235-2.4, HRS, every organization exempt from tax under section 235-9, HRS, shall keep permanent books of account or records, including inventories, which are sufficient to show specific items of gross income, receipts, and disbursements. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-102)

§18-235-102.5 to 18-235-108 (Reserved)

HRS §235-109 **§18-235-109 Jeopardy assessments, security for payments, etc.** (a) In general. Pursuant to sections 235-1 (defining "taxable year") and 235-109, HRS, and as set forth in section 231-24, HRS, a jeopardy assessment may be issued if the director determines that a taxpayer may depart quickly from the State, may remove or conceal the taxpayer's self or the taxpayer's property in or outside the State, or do any other act tending to prejudice or jeopardize, in whole or in part, the assessment or collection of any tax liability. A jeopardy assessment only terminates the taxable period for purposes of computing the amount of tax to be assessed and collected. Pursuant to section 231-24, HRS, tax liability for the taxable period in which a jeopardy assessment is made, may be recalculated.

(b) Tax for a short taxable year. Unlike the case of a short taxable year resulting from a change in accounting period made with the approval of the director, tax liability for a short taxable year resulting from a jeopardy assessment is not computed on an annual basis, and any available personal exemptions are not prorated. However, if tax liability for the taxable period is recalculated, the tax shall be recomputed over the entire period, including the portion which was subject to the jeopardy assessment. For example, if a jeopardy assessment is issued because a resident of the State is terminating residency and leaving the State, the taxpayer shall be allowed the full amount of any available personal exemptions and the tax liability shall be computed as if the income received during the short taxable year were the income for a taxable year of twelve months. However, if there is evidence that the taxpayer received income subject to taxation by the State after terminating residency, the director may recalculate the tax for the taxable period. The director shall recompute the tax for the entire twelve-month period, including the months which were subject to the previous jeopardy assessment, and any taxes paid on the previous jeopardy assessment shall be credited against any tax liability resulting from the twelve-month period.

(c) Recalculating tax liability after jeopardy assessment made. Where the taxable year has not yet expired, the director may recalculate the tax liability for a taxable period terminated by a jeopardy assessment each time the taxpayer is found to have received additional taxable income during the taxable year. The taxpayer may also reopen a taxable period terminated by a jeopardy assessment by filing a true and accurate return pursuant to chapter 235, HRS. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-109)

§18-235-110 to 18-235-110.5 (Reserved)

HRS §235-110.6 **§18-235-110.6 Fuel tax credit for commercial fishers.** (a) The tax credit provided by section 235-110.6, HRS, shall be equal to the amount of state and county fuel taxes imposed by section 243-4(a), HRS, upon all liquid fuel purchased for use by the principal operators of commercial fishing vessels.

(1) The fuel tax credit shall be available only to a principal operator who purchases and actually uses the fuel to operate a fishing vessel for commercial purposes. Taxes paid on fuel used for operating ancillary equipment on board the vessel, such as pumps, gasoline-powered winches, and other related equipment shall likewise qualify for the credit.

(2) The amount of credit shall be limited to the amount of tax paid by the principal operator for fuel which is actually used to operate the vessel. Fuel taxes paid upon fuel used in the operation of pickup trucks, airplanes, or any other purpose or use not directly related to the operation of the commercial fishing vessel shall not qualify for the credit.

Example 1: Taxpayer uses a pickup truck to deliver fish to market. The fuel used to operate the pickup truck is not directly related to the operation of the fishing vessel, and therefore, taxes paid on the fuel do not qualify for the credit.

Example 2: Taxpayer uses an airplane to scout the ocean for fish. Upon spotting a school of fish, a fishing vessel is dispatched for the haul. Taxes paid upon the fuel used to operate the airplane do not qualify for the credit; only taxes paid on fuel for the operation of the fishing vessel may be included in calculating the credit.

Example 3: Taxpayer conducts research and performs experiments for the University of Hawaii to improve commercial fishing techniques, methodology, and practices, for which the taxpayer receives payment. Because this is not primarily a commercial fishing endeavor, tax paid on fuel used in a research or experimental expedition shall not be included for credit.

(3) The fuel tax credit shall not apply to fuel used in the operation of charter fishing boats and the like, where the income is derived from fees and other sources rather than from commercial fishing.

(4) The fuel tax credit shall not apply to an individual or an electing small business corporation (S corporation) for fuel tax paid for fuel used in the operation of a fishing vessel where the activity is not engaged in for profit, as provided in section 183, IRC, (activities not engaged in for profit).

Example: Taxpayer retired and moved to Hawaii. She purchased a cabin cruiser which is used by taxpayer and her friends for fishing. When the catch of fish is in excess of the taxpayer's needs, the excess is sold. During the taxable year, the taxpayer grossed $35,000 from the sale of fish and received $50,000 of income exempt from state income tax. The taxpayer attached schedule "C" (Profit or (Loss) from Business or Profession) to both her state and federal individual income tax returns, resulting in a net loss from the fishing activity of $15,000. Taxpayer claimed a refundable credit for the amount of fuel tax paid on fuel used to operate the fishing vessel. The Internal Revenue Service reviewed the taxpayer's tax return and the loss was disallowed under section 183, IRC, as an activity not engaged in for profit.

Conclusion: The taxpayer's activity does not qualify for the fuel tax credit. The fishing activity is considered a hobby for purposes of section 183, IRC, not a commercial fishing operation.

(b) To qualify as a principal operator in order to claim the fuel tax credit under section 235-110.6, HRS, at least fifty-one per cent of the taxpayer's gross annual income must be derived from commercial fishing operations. Gross income, for purposes of this subsection, shall not include nontaxable income such as pensions, social security, welfare payments, and excluded interest.

Example: Taxpayer is retired from the military and receives a pension of $15,000 and interest from United States bonds of $2,000 for the taxable year. He leased a boat and engaged in commercial fishing for eight months of the taxable year. His gross income, taxable by Hawaii, from fishing was $16,000.

Conclusion: Since the taxpayer derived at least fifty-one per cent of his gross annual income from commercial fishing operations, he qualifies for the fuel tax credit in an amount equal to the fuel tax that he paid on fuel used to operate the commercial fishing vessel for the taxable year.

(c) For the purpose of determining whether commercial fishing activities make up at least fifty-one per cent of the taxpayer's gross annual income, only the gross income of the principal operator will be considered. The application of this provision is illustrated by the following examples:

Example 1: H and W (husband and wife) file a joint tax return for the taxable year. H is retired and receives a pension of $20,000 for the taxable year. His other income includes $10,000 in interest and $400 in dividends. During the taxable year H also derives $30,000 from commercial fishing operations. W receives $18,000 in wages and $12,000 in rent from rental property owned solely by her.

Conclusion: H may claim the fuel tax credit. For purposes of claiming the credit, only H's income is considered. Since his pension is excludable from gross income, the $30,000 derived from commercial fishing operations is greater than fifty-one per cent of his annual gross income, qualifying him for the fuel tax credit.

Example 2: A and B form a partnership, purchase a boat, and engage in commercial fishing. The annual gross income of the partnership derived from commercial fishing is $80,000. A and B equally share in the income and expenses of the partnership. In addition to the partnership income, A has wages of $20,000 and gross rents of $20,000. B receives, in addition to the partnership income, a federal pension of $25,000, interest from federal bonds of $5,000, Hawaii tax exempt bond interest of $15,000, and a net short term capital gain of $10,000.

Conclusion: Since A and B are equal partners, each is deemed to have $40,000 gross annual income from commercial fishing. A's gross income for the taxable year is $80,000. Since A did not derive at least fifty-one per cent of his gross annual income from the commercial fishing operation, he does not qualify for the fuel tax credit for commercial fishers. B's gross income for state purposes is $50,000. Since the $40,000 of gross income derived from commercial fishing activities exceeds fifty-one per cent of B's annual gross income, B qualifies for the fuel tax credit. B may only claim B's share, or one-half, of the fuel tax paid on fuel purchased for the commercial fishing vessel.

(d) The principal operator shall prepare such forms as may be prescribed by the director of taxation for purposes of claiming the fuel tax credit. The forms shall be submitted with the individual or corporate tax return for the taxable year for which the credit is claimed.

(e) The principal operator shall keep full, complete, regular, and accurate records sufficient to establish the amount of gross income received from commercial fishing activities, and the amount of fuel tax paid by the principal operator for the fuel used to operate the commercial fishing vessel. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.6)

HRS §235-110.7 **§18-235-110.7-01 Definitions.** For purposes of sections 18-235-110.7-01 to 18-235-110.7-22, unless otherwise stated:

"ACRS" means the accelerated cost recovery system.

"Credit" means the capital goods excise tax credit.

"Department" means the department of taxation.

"Director" means the director of taxation.

"Eligible property" means new section 38 property or used section 38 property (as defined in sections 18-235-110.7-05 and 18-235-110.7-06, respectively).

"I.R.C." means the Internal Revenue Code of 1954, as amended, which includes the Internal Revenue Code of 1986, and the Internal Revenue Code of 1986, as amended.

"Lease" is defined as it is for federal income tax purposes. For treatment, see section 18-235-110.7-02(c).

"Sale-leaseback" is defined as it is for federal income tax purposes. For treatment, see section 18-235-110.7-02(c). [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-02 Allowance of the credit.** (a) In general. There shall be allowed to each taxpayer subject to the tax imposed by chapter 235, HRS, a credit which shall be deductible from the taxpayer's net income tax liability, if any, for the taxable year in which the credit is properly claimed, if the following conditions are met:

(1) The taxpayer purchases or imports eligible property;

(2) The purchase or import of eligible property results in a transaction which is subject to the imposition and payment of tax at the rate of four per cent under chapters 237 or 238, HRS;

(3) The eligible property is used by the taxpayer in a trade or business;

(4) The eligible property is placed in service within Hawaii after December 31, 1987 (for property acquired during the period beginning January 1, 1988, to December 31, 1988, see section 18-235-110.7-09); and

(5) The taxpayer files a claim for the credit on or before the end of the twelfth month following the close of the taxable year for which the credit may be claimed, or if an extension of time for filing a return has been granted, within the extension period.

(b) Taxable year in which the credit is allowable. The credit shall be allowed only for the first taxable year in which the property is placed in service by the taxpayer.

(1) If a taxpayer places property in service in a taxable year and the property does not qualify as eligible property (or only a portion of the property qualifies as eligible property) in that year, no credit (or a credit only as to the portion which qualifies in that year) shall be allowed to the taxpayer with respect to the property. This is the rule notwithstanding that the property (or a greater portion of the property) qualifies as eligible property in a subsequent taxable year.

(2) Example. Paragraph (1) is illustrated as follows:

In 1988, a taxpayer places property in service and uses the property entirely for personal purposes. In 1989, the taxpayer begins using the property in a trade or business. In this case, no credit is allowable to the taxpayer, with respect to the property, for either 1988 or 1989.

(3) Constructed, reconstructed, or erected property which is placed in service over a span of more than one taxable year, see section 18-235-110.7-11.

(c) Taxpayer who is eligible for the credit in lease or sale-leaseback transactions.

(1) In general. The determination of the taxpayer who is entitled to the credit when the parties characterize a transaction as a lease or sale-leaseback (as defined in section 18-235-110.7-01) requires an analysis of whether the transaction is, in fact, a lease or sale-leaseback for federal income tax purposes. The characterization of a transaction as a lease or sale-leaseback determines who is the economic owner of the property and thereby entitled to the tax benefits (i.e., credit) associated with the property. Only one party, the economic owner of the property, is entitled to claim any available credit.

(2) Lease. If a transaction is a lease for federal income tax purposes, the lessor entering into a lease agreement with respect to property which is eligible for the credit is treated as the owner of the property. The lessor may thereby claim any available credit.

(3) Sale-leaseback. If a transaction is a sale-leaseback for federal income tax purposes, the buyer/lessor entering into a sale-leaseback arrangement with respect to property which is eligible for the credit is treated as the owner of the property. The buyer/lessor may thereby claim any available credit.

(4) Sale. If the parties characterize a transaction as a lease, but it is in reality a sale for federal income tax purposes, the lessee is the owner of the property. Assuming that the property is eligible for the credit, the lessee may thereby claim any available credit. Note that for purposes of this paragraph, the term "lessee" is used for convenience, without intending to suggest the propriety of the parties' characterization of the transaction as a lease.

(d) Solar and wind energy property. If a taxpayer is eligible for both the income tax credit under section 235-12, HRS (regarding solar or wind energy devices), and the capital goods excise tax credit for a particular solar or wind energy property, the credit under section 235-12, HRS, shall be deducted from the taxpayer's net income tax liability before the capital goods excise tax credit. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-03 Property eligible for the credit.** The determination of whether property is eligible for the credit must be made with respect to the first taxable year in which the property is placed in service by the taxpayer. Property which is eligible for the credit is (1) new section 38 property (as defined in section 18-235-110.7-05), or (2) used section 38 property (as defined in section 18-235-110.7-06). [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-04 Section 38 property.** (a) In general. Section 38 property is defined as:

(1) Property which is (A) tangible personal property, or (B) other tangible property;

(2) Recovery property (within the meaning of I.R.C. section 168, without regard to useful life), or any other property with respect to which depreciation is allowable to the taxpayer; and

(3) Property which has an estimated useful life or recovery period (determined as of the time the property is placed in service) of three years or more. A property shall have the same estimated useful life or recovery period as that which is used for depreciation or ACRS purposes.

(b) Tangible personal property.

(1) In general. Tangible personal property (other than a central air conditioning or heating unit), as defined in paragraph (2), may qualify as section 38 property regardless of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in subsection (c).

(2) "Tangible personal property", defined. For purposes of the credit, the term tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of the buildings or structures). The terms "building" and "structural components" are defined in subsection (1). Thus, buildings, swimming pools, paved parking areas, wharves, docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which are contained in or attached to a building. Property such as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which are contained in or attached to a building constitute tangible personal properties for purposes of the credit. Further, all property in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. For example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

(c) Other tangible property. In addition to tangible personal property, other tangible property (not including a building and its structural components) may qualify as section 38 property if one of the following three conditions is met:

(1) The property is used as an integral part (as defined in subsection (d)) of manufacturing, production, extraction, or furnishing transportation, communication, electrical energy, gas, water, or sewage disposal services;

(2) The property is a research or storage facility used in connection with an activity referred to in paragraph (1):

(A) Examples of research facilities include wind tunnels and test beds;

(B) Examples of storage facilities include oil and gas storage tanks;

(C) Although a research or storage facility must be used in connection with one of the specified activities in paragraph (1), the taxpayer-owner of the facility need not be engaged in the specified activity. For example, if a research or storage facility is used in connection with a manufacturing process, the taxpayer-owner of the facility need not be engaged in the manufacturing process; or

(3) The property is a facility used in connection with an activity referred to in paragraph (1) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).

(d) "Integral part", defined. Property is used as an integral part of one of the specified activities in subsection (c) if it is used directly in the activity and is essential to the completeness of the activity.

(1) Examples include fences used to confine livestock and telephone poles. In the case of manufacturing, for example, all properties used by a taxpayer to acquire or transport raw materials or supplies to the point where the actual processing commences (e.g., dock), or to process raw materials into the taxpayer's final product, are considered property used as an integral part of manufacturing.

(2) Property such as pavements, paved parking areas, inherently permanent advertising displays, inherently permanent outdoor lighting facilities, or swimming pools, although used in the operation of a business, ordinarily is not used as an integral part of any of the specified activities in subsection (c), and therefore does not qualify for the credit.

(3) Property shall be considered to be used as an integral part of one of the specified activities in subsection (c) if it is used by either the owner of the property or the lessee of the property.

(e) "Manufacturing, production, and extraction", defined. The terms manufacturing, production, and extraction include: (1) the construction, reconstruction, or making of property out of scrap, salvage, junk, new, or raw material by processing, manipulating, refining, or changing the form of an article, or by combining or assembling two or more articles; (2) the cultivation of the soil; (3) the raising of livestock; and (4) the mining of minerals. Examples include property used as an integral part of the extraction, processing, or refining of metallic and nonmetallic minerals; the construction of roads, bridges, or housing; the processing of meat, fish, or other foodstuffs; the cultivation of orchards, gardens, or nurseries; the production of lumber, lumber products, or other building materials; the fabrication or treatment of textiles, paper, or glass; and the rebuilding, as distinguished from the mere repairing, of machinery.

(f) "Transportation business", defined. A transportation business includes airlines, bus companies, shipping or trucking companies, and oil pipeline companies.

(g) "Communication business", defined. A communication business includes telephone, telegraph, or cable companies, and radio or television broadcasting companies.

(h) "Bulk storage", defined. Bulk storage means the storage of a commodity in a large mass prior to its consumption or use. For example, if a facility is used to store macadamia nuts which have not been sorted or processed, the facility is used for bulk storage; however, if a facility is used to store macadamia nuts that have been sorted and canned, it is not used for bulk storage.

(i) Recovery or depreciable property requirement. Section 38 property must be either recovery property (within the meaning of I.R.C. §168, without regard to useful life), or any other property with respect to which depreciation is allowable to the taxpayer.

(1) If only part of a property is depreciable, only a pro rata portion of the property may qualify as section 38 property.

(2) Example. Paragraph (1) is illustrated as follows:

A property is used 90 per cent of the time in a trade or business, and 10 per cent of the time for personal purposes. In this case, only 90 per cent of the basis of the property may qualify as section 38 property which is eligible for the credit.

(3) Property does not qualify as section 38 property to the extent that a deduction for depreciation thereon is disallowed under I.R.C. §274 (regarding the disallowance of certain entertainment, etc., expenses).

(j) Boilers fueled by oil or gas. Generally, any boiler, used in Hawaii, which is primarily fueled by petroleum or petroleum products (including natural gas) qualifies as section 38 property.

(k) Energy property.

(1) In general. Certain energy property qualifies as section 38 property. The energy property must be intended to reduce the amount of oil, natural gas, or other energy consumed in heating or cooling a building or used in an industrial process.

(2) "Energy property", defined. Energy property is:

(A) Alternative energy property. Alternative energy property consists of the following types of property:

(i) A boiler, the primary fuel for which will be an alternate substance. An alternate substance is any substance other than oil, natural gas, or any product of oil and natural gas;

(ii) A burner (including necessary on-site equipment to bring the alternate substance to the burner) for a combustor other than a boiler if the primary fuel for the burner will be an alternate substance;

(iii) Equipment for converting an alternate substance into a synthetic liquid, gaseous, or solid fuel;

(iv) Equipment designed to modify existing equipment which uses oil or natural gas as fuel or as feedstock so that the existing equipment will use either a substance other than oil and natural gas, or oil mixed with a substance other than oil and natural gas (where the other substance will provide not less than twenty-five per cent of the fuel or feedstock);

(v) Equipment to convert coal (including lignite), or any non-marketable substance derived therefrom, into a substitute for a petroleum or natural gas derived feedstock for the manufacture of chemicals or other products, or coal (including lignite), or any substance derived therefrom, into methanol, ammonia, or a hydroprocessed coal liquid or solid;

(vi) Pollution control equipment required (by federal, state, or local regulations) to be installed on or in connection with equipment described in clauses (i) to (v);

(vii) Equipment used for the unloading, transfer, storage, reclaiming from storage, and preparation (including, but not limited to, washing, crushing, drying, and weighing) at the point of use for an alternate substance for use in equipment described in clauses (i) to (vi). This includes equipment used for the storage of fuel derived from garbage at the site at which fuel was produced from garbage; and

(viii) Equipment used to produce, distribute, or use energy from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to (but not including), the electrical transmission state. A geothermal deposit is a

geothermal reservoir consisting of natural heat which is stored in rocks or in an aqueous liquid or vapor (whether or not under pressure). The deposit shall not be treated as a gas well.

(B) Solar or wind energy property. Solar or wind energy property means any equipment which uses solar or wind energy to:
- (i) Generate electricity;
- (ii) Heat or cool (or provide hot water for use in) a structure; or
- (iii) Provide solar process heat.

(C) Specially defined energy property. Specially defined energy property is property which is installed in an existing industrial or commercial facility to reduce the amount of energy consumed in the existing industrial or commercial process. The term includes a recuperator, heat wheel, regenerator, heat exchanger, waste heat broiler, heat pipe, automatic energy control system, turbulator preheater, combustible gas recovery system, economizer, modifications to alumina electrolytic cells, modifications to chlor-alkali electrolytic cells, or any other property of a kind specified by the department, the principal purpose of which is to reduce the amount of energy consumed in an existing industrial or commercial process and which is installed in an existing industrial or commercial facility.

(D) Recycling equipment.
- (i) In general. Recycling equipment includes any equipment which is used exclusively to sort and prepare solid waste for recycling or in the recycling of solid waste.
- (ii) Certain equipment not included. The term recycling equipment does not include any equipment used in a process after the first marketable product is produced or in the case of recycling iron or steel, any equipment used to reduce the waste to a molten state and in any process thereafter.
- (iii) Ten per cent virgin material allowed. Any equipment used in the recycling of material which includes some virgin materials shall not be treated as failing to meet the exclusive requirements of clause (i) if the amount of the virgin materials is ten per cent or less.
- (iv) Certain equipment included. The term recycling equipment includes any equipment which is used in the conversion of solid waste into a fuel or into useful energy such as steam, electricity, or hot water.

(E) Hydroelectric generating property. Hydroelectric generating property means property installed at a hydroelectric site which is:
- (i) Equipment for increased capacity to generate electricity by water (up to, but not including, the electrical transmission stage); and
- (ii) Structures for housing the generating equipment, fish passageways, and dam rehabilitation property, required by reason of the installation of equipment described in clause (i).

(F) Cogeneration equipment.
- (i) In general. Cogeneration equipment means property which is an integral part of a system for using the same fuel to produce both qualified energy and electricity at an industrial or commercial facility.
- (ii) "Qualified energy", defined. Qualified energy means steam, heat, or other forms of useful energy (other than electric energy) to be used for industrial, commercial, or space-heating purposes (other than in the production of electricity).
- (iii) "Industrial", defined. Industrial includes the purification of water and the desalinization of water.

(G) Biomass property qualifies for the credit. Biomass property means property which is a boiler, the primary fuel for which is an alternate substance, a burner (including necessary on-site equipment to bring the alternate substance to the burner) for a combustor other than a boiler if the primary fuel will be an alternate substance, or equipment for converting an alternate substance into a qualified fuel, including equipment used to store fuel derived from garbage at the site at which such fuel was produced from garbage. For purposes of defining biomass property, an alternate substance means any substance other than an inorganic substance and coal (including lignite) or any coal product. Biomass property also includes pollution control equipment which is required to be installed on or in connection with the above

equipment, as well as equipment used for the unloading, transfer, storage, reclaiming from storage, and preparation at point of use of an alternate substance for use in that equipment.

(l) Property which generally does not qualify as section 38 property. Certain classes of property which generally do not qualify as section 38 property and thereby are not eligible for the credit include:

(1) A building or its structural components.

(A) "Building", defined.

(i) In general. A building is any structure or edifice which encloses a space within its walls, and is usually covered by a roof. The purpose of the structure or edifice is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, among other structures, apartments, factory and office buildings, warehouses, barns, garages, bus stations, and stores. The term also includes any such structure which is constructed by or for a lessee, even if the structure must be removed, or ownership of the structure reverts to the lessor at the termination of the lease.

(ii) Property which is excluded from the definition of building and which thereby may be eligible for the credit. A building does not include a structure which is essentially an item of machinery or equipment; or a structure which houses property used as an integral part of manufacturing, producing, extracting, or furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services if the use of the structure is so closely related to the use of the property that the structure can be expected to be replaced when the property it initially houses is replaced.

(iii) Factors which indicate that a building or structure is closely related to the use of a particular property it houses include the following: the structure is specifically designed to provide for the stress and other demands of the property; and the structure could not be economically used for other purposes. Examples of such structures include oil and gas storage tanks, feed storage bins, silos, and crop shelters.

(B) "Structural component", defined.

(i) In general. A structural component includes parts of a building such as walls, partitions, floors, ceilings, and permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, on, or adjacent to the building) of a central air conditioning or heating system, including motors, compressors, pipes, and ducts; plumbing and plumbing fixtures (e.g., sinks and bathtubs); electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components relating to the operation or maintenance of a building.

(ii) Property which is excluded from the definition of structural component and thereby may be eligible for the credit. The term structural component does not include property which is contained in or attached to a building such as production machinery, the sole justification for the installation of which is to meet temperature or humidity requirements which are essential for the operation of other machinery or the processing of materials or foodstuffs. Machinery may meet this sole justification test even though it incidentally provides for the comfort of employees, or serves, to an insubstantial degree, areas where the temperature or humidity requirements are not essential.

(C) Whether property is classified as a structural component is largely determined by the manner of attachment to the land or the structure, and how permanently the property is designed to remain in place. The following are among the factors which the department may consider in making this determination:

(i) The manner of affixation (permanent or detachable) of the property to the land;

(ii) Whether the property is capable of being moved, and whether it has in fact been moved;

(iii) Whether the property is designed or constructed to remain permanently in place;

(iv) Circumstances which tend to show the expected or intended length of affixation;

(v) Whether the removal of the property is substantial and time consuming;

(vi) Whether the property is readily removable; and

(vii) The extent of damage that the property will sustain if it is removed.

(2) Property purchased for use in a foreign trade zone (as defined under chapter 212, HRS).

(3) Property used by an organization which is exempt from the tax imposed by chapter 235, HRS, unless the property is used predominantly in an unrelated trade or business, the income from which is subject to tax under chapter 235, HRS (with respect to the imposition of tax on unrelated business income of charitable, etc., organizations).

(A) "Property used by an organization", defined. Property used by an organization means property owned by the organization.

(B) Example. Subparagraph (A) is illustrated as follows:

A tax-exempt organization which is not subject to the imposition of tax under chapter 235, HRS, places in service a copying machine. The copying machine is used in an income producing activity which is subject to taxation under chapter 237, HRS. The tax-exempt organization has no unrelated trade or business income subject to tax under chapter 235, HRS (with respect to the imposition of tax on unrelated business income of charitable, etc., organizations). The copying machine would be considered to be property used by the organization. Although the copying machine may otherwise qualify for the credit, since the organization is not a taxpayer subject to the imposition of tax under chapter 235, HRS, the organization cannot claim a credit for the copying machine.

(4) Intangible property (e.g., patent, copyright, subscription list).

(5) Property used for lodging.

(A) "Property used for lodging", defined. Property used for lodging is property which is used predominantly to furnish lodging; or in connection with the furnishing of lodging.

(i) "Property used predominantly to furnish lodging", defined. Property used predominantly to furnish lodging includes that which is used in the living quarters of a lodging facility (e.g., beds, other furniture, refrigerators, ranges, and other equipment).

(ii) "Lodging facility", defined. A lodging facility includes an apartment house, hotel, motel, dormitory, or other facility (or part of a facility) where sleeping accommodations are provided and let; however, the term does not include a facility which is used primarily as a means of transportation (e.g., aircraft, vessel) or to provide medical or convalescent services, even though sleeping accommodations are provided.

(iii) "Property used predominantly in connection with the furnishing of lodging", defined. Property used predominantly in connection with the furnishing of lodging includes that which is used to operate a lodging facility or to serve tenants, whether furnished by the owner of the lodging facility or another person (e.g., lobby furniture, office equipment, laundry, and swimming pool facilities). However, property used in furnishing, to the management of a lodging facility or its tenants, electrical energy, water, sewage disposal services, gas, telephone services or other similar utility services shall not be treated as property used in connection with the furnishing of lodging (e.g., gas and electric meters, telephone poles and lines, telephone station and switchboard equipment, and water and gas mains which are furnished by a public utility).

(B) Exceptions.

(i) A nonlodging commercial facility which is available to persons not using the lodging facility on the same basis as it is available to tenants of the lodging facility may qualify as section 38 property which may be eligible for the credit. Examples include restaurants, drug stores, grocery stores, and vending machines located in the lodging facility.

(ii) Property used by a hotel, motel, or other similar establishment in connection with the trade or business of furnishing lodging where the predominant portion (i.e., more than one-half) of the accommodation in the hotel, motel, or other similar establishment is used by transients may qualify as section 38 property which is eligible for the credit. An accommodation shall be considered to accommodate transients if the rental period is normally less than thirty days. Thus, if greater than one-half of the living quarters of a hotel, motel, or other similar establishment is used during the taxable year to accommodate transients, the property used by the hotel, motel, or other similar establishment may qualify as section 38 property. On the other hand, if one-half or less of the living

quarters of a hotel, motel, or other similar establishment is used during the taxable year to accommodate transients, the property used by the hotel, motel, or other similar establishment would not qualify as section 38 property.

(iii) Coin-operated vending machines and coin-operated washing machines and dryers may qualify as section 38 property.

(m) The definition of section 38 property is limited to the provisions in this section. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-05 New section 38 property.** For calendar year 1988 (and fiscal year taxpayer acquisitions occurring during the period beginning January 1, 1988, to December 31, 1988), and for calendar years beginning after December 31, 1988 (and fiscal year taxpayer acquisitions occurring after December 31, 1988). Property qualifies as new section 38 property if one of the following conditions is met:

(1) Section 38 property, the original use of which commences with the taxpayer after December 31, 1987, and commences after the date the taxpayer acquires it.

(A) "Original use", defined. Original use means the first use to which the property is put, whether or not it is the taxpayer's first use of the property.

(B) Examples. Subparagraph (A) is illustrated as follows:

Example 1. A taxpayer purchases a reconditioned or rebuilt machine. In this case, the property would not qualify as new section 38 property because the taxpayer would not be treated as the first user of the property; however, the property may qualify as used section 38 property (as discussed in section 18-235-110.7-06).

Example 2. A florist purchases antique bread racks to serve as display cases for the plants in the shop. The florist will not be treated as the original user of the racks. The fact that the racks serve a new purpose does not change their used property status.

(2) Section 38 property which is:

(A) Sold and leased back by the same taxpayer within three months of the date the property was originally placed in service by the taxpayer; or

(B) Leased to the same taxpayer within three months of the date the property was originally placed in service by that taxpayer.

(C) Example. Subparagraph (B) is illustrated as follows:

Taxpayer A ("A") buys property from a manufacturer, takes delivery of the property, and places it in service before A has its financing in place. Shortly thereafter, A sells it (or assigns the purchase order) to Taxpayer B, who then leases it to A.

(3) Section 38 property, the construction, reconstruction, or erection of which is placed in service by the taxpayer after December 31, 1987, but only with respect to that portion of the basis as is discussed in section 18-235-110.7-11(c).

(A) It is not necessary that the materials entering into the construction, reconstruction, or erection be new in use.

(B) Construction, reconstruction, or erection begins when physical work is started on the construction, reconstruction, or erection.

(C) See section 18-235-110.7-11(c) for a discussion of the basis of new section 38 property which has been constructed, reconstructed, or erected. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-06 Used section 38 property.** (a) For calendar year 1988 (and fiscal year taxpayer acquisitions occurring during the period beginning January 1, 1988, to December 31, 1988). Property qualifies as used section 38 property if:

(1) The property is section 38 property (as defined in section 18-235-110.7-04);

(2) The property is not new section 38 property (as defined in section 18-235-110.7-05); and

(3) The property is not used by the same person (i.e., taxpayer or a related person as defined in I.R.C. §179(d)(2)(A) or (B)) both before and after the purchase.

(A) Use by prior user. Property shall not be treated as used section 38 property if the property is used by the same person (i.e., taxpayer or a related person) both before and after its purchase.

(B) Substantial use. While used section 38 property must not be used by the same person both before and after its purchase, only substantial use before a purchase disqualifies used property for purposes of the credit. Casual use before a purchase would not disqualify used property from eligibility for the credit.

(C) Example. Subparagraph (B) is illustrated as follows:

A person rents equipment (1) for a period of 25 days and for a different 2-day period within eleven months of the first rental, and (2) then purchases the equipment. In this case, the prior use of the property will not disqualify it as used section 38 property because the prior use will be considered to have been only on a casual basis.

(D) Lease or sale-leaseback. Property sold under a sale-leaseback arrangement in the hands of the buyer/lessor does not qualify as used section 38 property because the seller/lessee continues to use the property. The same result follows where a taxpayer who has been leasing property subsequently purchases the property it had leased. Note that section 38 property which is (i) sold and leased back by the same taxpayer within three months of the date the property was originally placed in service by the taxpayer, or (ii) leased to the same taxpayer within three months of the date the property was originally placed in service by that taxpayer may qualify as new section 38 property (see section 18-235-110.7-05(2)).

(b) For calendar years beginning after December 31, 1988 (and fiscal year taxpayer acquisitions occurring after December 31, 1988). Property qualifies as used section 38 property if:

(1) The property is section 38 property (as defined in section 18-235-110.7-04); and

(2) The property is not new section 38 property (as defined in section 18-235-110.7-05).

(c) Basis. See section 18-235-110.7-11(d) for a discussion of the basis of used section 38 property. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-07 Purchase.** Purchase means an acquisition of property. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-08 Placed in service.** (a) In general. Property shall be considered to be placed in service in the earliest of the following taxable years:

(1) The taxable year in which the period for depreciation with respect to the property begins;

(2) The taxable year in which under ACRS, a claim for recovery allowances with respect to the property begins; or

(3) The taxable year in which the property is placed in a condition or state of readiness and available for a specifically assigned function by the taxpayer. The following examples illustrate paragraph (3):

(A) Parts that are acquired and set aside during the taxable year for use as a replacement for a particular machine in order to avoid operational time loss shall be considered to be in a condition or state of readiness and available for a specifically assigned function by the taxpayer.

(B) If operational farm equipment is acquired during the taxable year and it is not practicable to use the equipment for its specifically assigned function in the taxpayer's business of farming until the following year, the equipment shall be considered to be in a condition or state of readiness and available for a specifically assigned function by the taxpayer in the latter year.

(C) Equipment that is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate defects shall be considered to be in a condition or state of readiness and available for a specifically assigned function by the taxpayer.

(D) Fruit-bearing trees and vines shall not be considered to be in a condition or state of readiness and available for a specifically assigned function until they have reached an income-producing state.

(E) Materials and parts acquired to be used in the construction, reconstruction or erection of an item of equipment shall not be considered to be in a condition or state of readiness and available for a specifically assigned function until the equipment itself is functional.

(b) Sale-leaseback. In a sale-leaseback transaction (as defined in section 18-235-110.7-01), the property shall be considered to be placed in service on the date the property was first placed in service by the seller-lessee. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-09 Purchased and placed in service.** (a) In general. The discussion in this section only applies to claims for and recapture of credit for property acquired during calendar year 1988, and for fiscal year taxpayer acquisitions occurring during the period beginning January 1, 1988, to December 31, 1988. From January 1, 1988, to December 31, 1988, all references in sections 18-235-110.7-01 to 18-235-110.7-22 to the phrase, "placed in service", shall be substituted by the phrase, "purchased and placed in service". As a result, for property acquired during the period from January 1, 1988, to December 31, 1988, the date corresponding to the substituted phrase, "purchased and placed in service", shall determine both the availability and recapture of any credit.

(b) "Purchased and placed in service", defined. Purchased and placed in service means the date the property is acquired, available or ready for use, whichever is earlier. Property purchased and placed in service does not include property which is acquired in a related-party transaction.

(c) "Related-party transaction", defined. A related-party transaction is a transaction in which:

(1) The acquired property is owned or used at any time during 1987 and 1988 by the taxpayer or related person; or

(2) The property is acquired in a transaction in which the user of the property does not change.

(d) "Related person", defined. A related person is:

(1) A person whose relationship to a person who is acquiring its property would result in the disallowance of losses under I.R.C. §267 or 707(b) (but, in applying I.R.C. §267(b) and 267(c) for purposes of this paragraph, paragraph (4) of I.R.C. §267(c) shall be treated as providing that the family of an individual shall include only the individual's spouse, ancestors, and lineal descendants); or

(2) One component member of a controlled group who acquires property from another component member of the same controlled group. The term component member of a controlled group is defined by I.R.C. §1563(a), except that the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in I.R.C. §1563(a)(1).

(e) Examples. Subsection (b) is illustrated as follows:

Example 1. In 1988, a taxpayer pays the entire purchase price for eligible property which is to be delivered in 1989. The taxpayer takes possession of the property in 1989. The property shall be considered to have been purchased and placed in service in 1988.

Example 2. In 1988, a taxpayer pays one-half of the entire purchase price for eligible property which is to be delivered in 1989. The taxpayer pays the remaining purchase price and takes possession of the property in 1989. The property shall be considered to have been purchased and placed in service in 1988.

Example 3. In 1988, a taxpayer takes possession of and uses eligible property for which the taxpayer makes no payment in 1988, but for which the taxpayer will make full payment in 1989. The taxpayer does in fact pay the entire purchase price for the property in 1989. The property shall be considered to have been purchased and placed in service in 1988.

Example 4. In 1988, a taxpayer enters into an installment sales contract to purchase eligible property and takes possession of the property. The property shall be considered to have been purchased and placed in service in 1988.

Example 5. In 1988, a taxpayer enters into an installment sales contract to purchase eligible property. The taxpayer takes possession of the property in 1989. The property shall be considered to have been purchased and placed in service in 1988.

Example 6. In 1987, a taxpayer pays the entire purchase price for eligible property which is to be delivered in 1988. The taxpayer takes possession of the property in 1988. The property shall be considered to have been purchased and placed in service in 1987 and thereby is not eligible for the credit.

Example 7. In 1987, a taxpayer takes possession of and uses eligible property for which the taxpayer makes no payment in 1987, but for which the taxpayer will make full payment in 1988. The taxpayer does in fact pay the entire purchase price for the property in 1988. The property shall be considered to have been purchased and placed in service in 1987 and thereby is not eligible for the credit.

(f) Examples. Subsections (b), (c), and (d) are illustrated as follows:

Example 1. Taxpayer A is in the business of selling tractors. In 1987, A purchases tractors and holds them as inventory. In 1988, A sells tractors to Taxpayers B and C, both of whom use the tractors in their businesses which are located in Hawaii. B is in the business of landscaping and C is in the business of roofing. Assume that the tractors qualify as eligible property in the hands of B and C (i.e., new section 38 property). The sales to B and C are subject to the imposition and payment of tax at the rate of four per cent under chapter 237, HRS. A and B are not related parties. A and C are related parties (i.e., C is a wholly owned subsidiary of A). In this case, assuming that B files a timely claim for the credit on the tractor purchase, B is eligible to receive a credit—B purchases eligible property; the purchase of the eligible property results in a transaction which is subject to the imposition and payment of tax at the rate of four per cent under chapter 237, HRS; and the eligible property is purchased and placed in service within Hawaii after December 31, 1987. C, on the other hand, is not eligible to receive a credit for the tractor—while C's purchase of eligible property results in the imposition and payment of tax at the rate of four per cent under chapter 237, HRS, the tractor is not considered to be purchased and placed in service since the tractor was owned during 1987 by a related person (i.e., A).

Example 2. Taxpayer A is in the business of selling flowers. In 1987, A purchases tractors for use in the flower business. A does not hold the tractors as inventory since A is not in the business of selling tractors. In 1988, A sells the tractors to Taxpayer B and C. B is in the business of landscaping and C is in the business of roofing. Assume that the tractors qualify as eligible property in the hands of B and C (i.e., used section 38 property). The sales to B and C are not subject to the imposition and payment of tax at the rate of four per cent under chapter 237, HRS, because the transactions constitute "casual sales" within the meaning of section 237-1, HRS, which are exempt from general excise taxation. In this case, neither B nor C is eligible to receive a credit for the purchase of the tractors because the tractor sales were not subject to the imposition and payment of tax at the rate of four per cent under chapter 237, HRS. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-10 Determination of amount of credit.** (a) The amount of credit available is determined by applying the following rates against the basis of eligible property:

(1) For calendar years prior to 1988, there is no credit;
(2) For calendar year 1988, the rate is three per cent;
(3) For calendar years beginning after December 31, 1988, the rate is four per cent; and
(4) For taxpayers with fiscal taxable years, the rate is the rate for the calendar year in which the eligible property is placed in service within Hawaii.

(b) Limitation on credit for eligible property for which a credit for sales or use taxes paid to another state is allowable under section 238-3(i), HRS. In the case of eligible property for which a credit for sales or use taxes paid to another state is allowable under section 238-3(i), HRS, the amount of capital goods excise tax credit allowable shall not exceed the amount of use tax actually paid under chapter 238, HRS, with regard to the eligible property. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-11 Basis of eligible property.** (a) In general. The basis of eligible property means the cost of property.

(b) "Cost", defined. Cost of property means the lesser of either:

(1) The actual invoice price of eligible property; or
(2) The basis from which a deduction is taken under I.R.C. §167 (with respect to depreciation) or under I.R.C. §168 (with respect to ACRS).

In either case, the amount under paragraph (1) or (2) must be subject to the imposition and payment of tax at the rate of four per cent under chapter 237 or 238, HRS.

(c) New section 38 property.

(1) In general. The basis of new section 38 property which has been constructed, reconstructed, or erected for the taxpayer's use includes that portion of the cost of the property which is (A) placed in service after December 31, 1987, and (B) subject to the imposition and payment of tax at the rate of four per cent under chapter 237 or 238, HRS. The portion of the cost of the property which is placed in service before January 1, 1988, is not eligible for the credit.
(2) Whether the cost or other basis of the construction, reconstruction, or erection is attributable to all or part of a property placed in service before or after December 31, 1987, may be determined by engineering estimates or by cost accounting records.

(3) In the case of reconstructed property, the cost of property does not include the adjusted basis of the reconstructed property at the time the reconstruction commences. However, after December 31, 1988, the reconstructed property may qualify as used section 38 property (as discussed in section 18-235-110.7-06), and the cost of the property may include the adjusted basis of the reconstructed property at the time the reconstruction commences if the adjusted basis of the property is subject to the imposition and payment of tax at the rate of four per cent under chapter 237 or 238, HRS.

(4) Examples: Paragraphs (1), (2), and (3) are illustrated as follows:

Example 1. In 1989, a taxpayer reconditions a machine which the taxpayer constructed and placed in service in 1987. The machine has an adjusted basis of $9,000 in 1987. The cost of materials in the reconditioning process which are subject to the imposition and payment of tax at the rate of four per cent under chapter 237, HRS, is $3,000. The basis of the machine which shall be taken into account to compute the amount of credit for 1989 is $3,000, regardless of whether the materials used for reconditioning are new in use.

Example 2. A machine with a total cost of $100,000 is placed in service after December 31, 1987. The cost of materials attributable to construction by the taxpayer and which is subject to the imposition and payment of tax at the rate of four per cent under chapter 237, HRS, is $30,000. In this case, the $30,000 amount shall be taken into account by the taxpayer as the basis to determine the amount of credit allowable for the new section 38 property.

(5) Constructed, reconstructed, or erected property which is placed in service over a span of more than one taxable year. If constructed, reconstructed, or erected property, qualifying as eligible property, is placed in service over a span of more than one taxable year, the credit shall be allowed to the taxpayer for a particular taxable year with respect to so much of the eligible property that is (A) placed in service after December 31, 1987, and (B) subject to the imposition and payment of tax at the rate of four per cent under chapter 237 or 238, HRS, in that taxable year.

(6) Example. Paragraph (5) is illustrated as follows:

In 1988, X Corporation enters into a long-term contract with Y Corporation, a builder, to construct energy properties. Assume that the energy properties qualify as eligible properties. Assume further that in 1988, (1) 25 per cent of the eligible properties are placed in service, and (2) subject to the imposition and payment of tax at the rate of four per cent under chapter 237, HRS. In 1988, X is allowed a credit with respect to the eligible properties which are placed in service and for which a tax at the rate of four per cent is imposed and paid under chapter 237, HRS. For succeeding taxable years, X is allowed an additional credit for the additional percentages of the eligible properties which are placed in service and for which a tax at the rate of four per cent under chapter 237, HRS, is imposed and paid as of the close of that subsequent taxable year.

(d) Used section 38 property. The basis of used section 38 property is the cost of the property which is subject to the imposition and payment of tax at the rate of four per cent under chapter 237 or 238, HRS. The dollar limitations on the cost of used section 38 property as stated in I.R.C. §48(c)(2)(A), (B), (C), or (D), as amended as of December 31, 1984, do not apply for purposes of the credit.

(e) Basis for eligible property of a partnership, S corporation, estate, or trust. In the case of a partnership, S corporation, estate, or trust, the credit allowable is for eligible property which is placed in service by the entity. The basis upon which the credit is computed is determined at the entity level. Each partner, S corporation shareholder, or beneficiary of an estate or trust shall separately take into account for its taxable year with or within which the entity's taxable year ends, the partner's, shareholder's, or beneficiary's share of the basis and resulting credit. A partner's share of the basis shall be determined in accordance with the ratio (in effect on the date on which the eligible property is placed in service) in which the partners divide the general profits of the partnership. The basis of partnership eligible property which is subject to a special allocation that is recognized under I.R.C. §704(a) and 704(b) (with respect to partner's distributive share), shall be recognized for purposes of the credit, and an upward basis adjustment pursuant to I.R.C. §754 (regarding manner of electing optional adjustment to basis of partnership property) is not eligible for the credit. A basis adjustment under I.R.C. §754 is not eligible for the credit because the adjustment is not a transaction which is subject to the imposition and payment of tax at the rate of four per cent under chapter 237 or 238, HRS. Each S corporation shareholder's basis of eligible property is the shareholder's allocated share of the corporation's basis in the eligible property. A beneficiary's share of the basis is apportioned between the entity and the beneficiaries, based on

the income of the entity allocable to each on the date the eligible property is placed in service. The term "beneficiary" includes an heir, legatee, or devisee.

(f) Examples. Subsection (e) is illustrated as follows:

Example 1. Partnership ABCD places in service on January 1, 1988, and September 1, 1988, items of eligible property. Partnership ABCD and each of its partners report income on the calendar year basis. Partners A, B, C, and D share partnership profits equally. Each partner's share of the basis of each eligible property which was placed in service by partnership ABCD is 25 per cent, and each partner's credit is 25 per cent of the total credit allowable for the eligible property.

Example 2. Assume the facts as in example 1 and the following additional facts. Partner A dies on June 30, 1988, and partner B purchases partner A's interest as of that date. Each partner's share of the profits from January 1, to June 30, is 25 per cent. From July 1, to December 31, B's share of the profits is 50 per cent, and partners C and D's share of the profits is 25 per cent each. For partner A's last taxable year (i.e., January 1, to June 30, 1988), partner A's share of the basis and resulting credit for eligible property which was placed in service on January 1, is 25 per cent. Partner B shall take into account 25 per cent of the basis and resulting credit for eligible property which was placed in service on January 1, and 50 per cent of the basis of the eligible property which was placed in service on September 1. Partners C and D shall each take into account 25 per cent of the basis and resulting credit for each eligible property which was placed in service by the partnership in 1988.

(g) Basis limitation if a deduction is taken under I.R.C. §179. If a deduction is taken under I.R.C. §179 (regarding an election to expense certain depreciable business assets), the portion of the basis of property for which the deduction is taken is not considered in determining the amount of credit allowable.

(h) Example. Subsection (g) is illustrated as follows:

A taxpayer purchases section 179 property (as defined in I.R.C. §179(d)) for $5,000. The taxpayer elects to treat $2,000 of the cost of the property as an expense under I.R.C. §179(d). In this case, the taxpayer shall only be allowed to compute the credit on a basis of $3,000 ($5,000 -$2,000).

(i) Basis limitation for automobiles. For purposes of determining the amount of credit available, the basis for passenger automobiles used predominantly (over fifty per cent) for business purposes is limited to $11,250.

(1) The limit applies to four-wheeled vehicles rated at six thousand pounds or less which are manufactured principally for use on public roads. The limit does not apply to an ambulance, hearse, truck, van, or other vehicle used directly in the trade or business of transporting persons or property for compensation or hire.

(2) This limitation applies prior to any percentage reduction for personal use (as discussed in section 18-235-110.7-11(j)).

(3) If more than one taxpayer have an interest in a passenger automobile, they are treated as one taxpayer for purposes of the basis limitation. The limitation is to be apportioned among the taxpayers according to their interests in the automobile.

(4) Examples. Subsection (i) is illustrated as follows:

Example 1. A calendar-year taxpayer places in service a $20,000 passenger automobile for business use in taxable year 1989. The maximum credit allowable in this case is $450 ($11,250 x 4%).

Example 2. If the taxpayer in example 1 uses the automobile for personal purposes 25 per cent of the time in the year the automobile is placed in service, the maximum credit allowable is $337.50 ($11,250 x 75% x 4%).

(j) Basis limitation for listed property which does not satisfy the more-than-fifty per cent business use test. Listed property will not be treated as eligible property, and the credit is denied if the listed property does not satisfy the more-than-fifty per cent business use test.

(1) "Listed property", defined. Listed property is generally defined as passenger automobiles and other property used as a means of transportation; property generally used for purposes of entertainment, recreation, or amusement; computers and related peripheral equipment; and other property as determined by the department.

(2) "The more-than-fifty per cent business use test", defined. The more-than-fifty per cent business use test requires that certain business use of listed property (referred to as qualified business use) exceeds fifty per cent.

(A) "Qualified business use", defined. For purposes of determining the more-than-fifty per cent business use test, use in a trade or business does not include use in an investment or other activity conducted for the production of income. However, if the more-than-fifty per cent business use test has been met, the percentage of investment use may be added in when figuring the total business use for purposes of calculating the amount of credit allowable.

(B) Examples. Subparagraph (A) is illustrated as follows:

Example 1. The taxpayer places in service in 1989, listed property that is used 45 percent for qualified business use and 55 per cent for investment purposes. In this case, since the qualified business use does not satisfy the more-than-50 per cent business use test, no credit is allowable.

Example 2. A calendar year taxpayer places in service in 1989, listed property with a cost of $5,000. The listed property is used 55 per cent for qualified business use, 35 per cent for investment activities, and 10 per cent for personal purposes. In this case, since the more-than-50 per cent business use test has been met, the percentage of investment use may be added in when figuring the total business use for purposes of calculating the amount of credit allowable. The credit is thereby determined and allowed on 90 per cent (55% + 35%) of the basis which is the combined business use. The credit allowable is $180 (90% x $5,000 x 4%).

(3) If the qualified business use satisfies the more-than-fifty per cent business use test, but is not used one hundred per cent for business, the amount of credit is limited to the percentage of business use.

(4) Example. Paragraph (3) is illustrated as follows:

A listed property is used 60 per cent for business and is otherwise eligible for the credit. In this case, the taxpayer is allowed to determine the amount of credit based on only 60 percent of the basis.

(5) The amount of credit allowable in the taxable year in which the listed property is placed in service is unaffected by any increase in the business use percentage in a subsequent year. However, if there is a reduction in the business use of property, then the credit taken with respect to the listed property may be subject to recapture (as discussed in section 18-235-110.7-15(b)). [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-12 Amount of credit allowable and claimed is treated as a taxable income item, or the basis of eligible property for depreciation or ACRS purposes is reduced by the amount of credit allowable and claimed.** The taxpayer shall treat the amount of credit allowable and claimed as a taxable income item for the taxable year in which it is properly recognized under the method of accounting used to compute taxable income. Alternatively, the basis of eligible property for depreciation or ACRS purposes for state income taxes shall be reduced by the amount of credit allowable and claimed. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-13 Recapture of credit under section 235-110.7, HRS.** (a) In general. Subject to exceptions as discussed in section 18-235-110.7-16, a recapture rule applies to recompute previously taken credit if eligible property is disposed of or otherwise ceases to be eligible property within the recapture period. The recapture rule is limited to the statements in sections 18-235-110.7-01 to 18-235-110.7-22. See section 18-235-110.7-15 for a discussion of when property ceases to be eligible property.

(b) "Recapture period", defined. The term recapture period means the period beginning on the first day of the month the eligible property is placed in service, and extending for a full three years.

(c) Recomputation. The credit is recomputed by multiplying the previously taken credit by a recapture percentage, and there should be taken into account any prior recapture determination in connection with the same property.

(d) Recaptured amount treated as increase in income tax. An increase in income tax as a result of credit recapture shall be treated as income tax imposed on the taxpayer by chapter 235, HRS, for the recapture year. This is

the rule notwithstanding that absent the recapture event, the taxpayer has no income tax liability, has a net operating loss, or no income tax return is otherwise required for the taxable year. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-14 Recapture percentage.** (a) The following table determines the recapture percentage.

Recapture period: If the recovery property or depreciable property ceases to be eligible property within:	The recapture percentage is:
(i) One full year after placed in service	100%
(ii) One full year after the close of the period described in clause (i)	66%
(iii) One full year after the close of the period described in clause (ii)	33%
(iv) One full year after the close of the period described in clause (iii), and thereafter	-0-

(b) Example. Subsection (a) is illustrated as follows:

On June 15, 1989, calendar-year taxpayer A places in service eligible property with a basis of $10,000. The asset is used entirely for business purposes. The amount of credit allowable and taken in taxable year 1989 is $400 ($10,000 x 4%). On June 16, 1991, A sells the asset. In taxable year 1991, A must recapture $132 [[($10,000 x 100% x 4%) - ($10,000 x 0% x 4%)] x 33%] of the previously taken credit. The 33% recapture percentage is based on a recapture period which begins on June 1, 1989 (i.e., the first day of the month within which the eligible property was placed in service), and the date the property ceases to be eligible property (i.e., June 16, 1991). [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-15 Recapture event (i.e., property ceases to be eligible property).** (a) In general. Property ceases to be eligible property with respect to a taxpayer:

(1) As a result of the occurrence of an event on a specific date (e.g., a sale, transfer, retirement, gift, distribution, or other disposition). The cessation shall be treated as having occurred on the actual date of the event; or

(2) For any reason other than the occurrence of an event on a specific date (e.g., the property is used predominantly in connection with the furnishing of lodging during the taxable year and does not fall within one of the exceptions; decrease in business use of listed property). The cessation shall be treated as having occurred on the first day of the taxable year.

(b) Decrease in the business use of listed property to less than fifty percent. During the recapture period, all or a portion of the credit taken in an earlier year for listed property may be subject to recapture if: (1) the percentage of business use falls below the percentage of business use for the year the listed property was placed in service; or (2) the listed property is converted from business use to personal use and does not satisfy the more-than-fifty per cent business use test. The terms "listed property" and "the more-than-fifty per cent business use test" are defined in section 18-235-110.7-11(j).

(c) Example. Subsection (b) is illustrated as follows:

A, a calendar-year taxpayer, places in service on January 15, 1988, listed property (i.e., automobile) for $7,000. In 1988, A uses the automobile 75 percent for business, 15 percent for the production of income, and 10 per cent for personal use. For taxable year 1988, A claims a credit in the amount of $189 ($7,000 x 90% x 3%). In 1989, A uses the automobile 60 per cent for business, 15 per cent for the production of income, and 25 per cent for personal use. The increased personal use triggers partial recapture of the credit of $20.79 [[($7,000 x 90% x 3%) -($ 7,000 x 75% x 3%)] x 66%]. In 1990, A uses the automobile 50 per cent for business, 25 per cent for the production of income, and 25 per cent for personal use. Although recapture is not required on the basis that the percentage of personal use remains the same in taxable years 1989 and 1990, I.R.C. §280F, which is adopted by section 235-110.7(d), HRS, requires recapture because the automobile ceases to be eligible property for failure to satisfy the more-than-50 per cent business use test. Accordingly, A must recapture a further $51.98 [[($7,000 x 75% x 3%) -($7,000 x 0% x 3%)] x 33%].

(d) Decrease in basis of eligible property. During the recapture period, all or a portion of previously taken credit may be subject to recapture as a result of a cessation such as a decrease in the basis of eligible property (either through a refund in purchase price or usage of the property for personal purposes).

(e) Example. Subsection (d) is illustrated as follows:

A, a calendar-year taxpayer, places in service on January 1, 1988, property, which is not listed property, with a basis of $20,000. In taxable year 1988, A uses the property 80 per cent for business, and 20 per cent for personal purposes. Thus, for taxable year 1988, only 80 per cent, or $16,000 ($20,000 x 80%) of the basis of the asset qualifies as eligible property. The credit allowable in 1988 is $480 ($16,000 x 3%). In taxable year 1989, A uses the asset 60 per cent for business, and 40 per cent for personal purposes. The increased personal use triggers partial recapture of the credit in taxable year 1989 of $79.20 [[($20,000 x 80% x 3%) - ($20,000 x 60% x 3%)] x 66%].

(f) Partnership, S corporation, estate, or trust.

(1) In general. In the case of a partnership, S corporation, estate, or trust, the recapture rule applies to a partner, shareholder, or beneficiary who originally received the benefit of a credit if within the recapture period: (A) the S corporation, partnership, estate, or trust disposes of eligible property (or if eligible property otherwise ceases to be eligible property in the hands of the entity); or (B) the partner's, shareholder's, or beneficiary's interest in the entity is reduced (for example, by a sale of the partner's, shareholder's, or beneficiary's interest in the entity) below a specified percentage. See section 18-235-110.7-16 for exceptions to the recapture rule for transfers by reason of death of a partner, and a downward basis adjustment pursuant to I.R.C. §754 (regarding manner of electing optional adjustment to basis of partnership property).

(2) "Specified percentage", defined. The term specified percentage is defined by the following two rules:

(A) 66 2/3 per cent rule; and

(B) 33 1/3 per cent rule.

(3) "66 2/3 per cent rule", defined. The 66 2/3 per cent rule means that if a partner's, shareholder's, or beneficiary's interest in the entity is reduced below 66 2/3 per cent of its interest at the time the credit was taken, a pro rata share of the partner's, shareholder's, or beneficiary's interest in the entity's eligible property will cease to be eligible property with respect to the partner, shareholder, or beneficiary, and credit recapture will be required.

(4) "33 1/3 per cent rule", defined. The 33 1/3 per cent rule means that once there has been a recapture by reason of the 66 2/3 per cent rule, there is no further recapture until the partner's, shareholder's, or beneficiary's interest is reduced to less than 33 1/3 per cent of its interest at the time the credit was taken. Thereafter, any reduction in interest, however small, will again subject the partner, shareholder, or beneficiary to the recapture provisions.

(5) Prior recapture determination. In making a recapture determination, there should be taken into account any prior recapture determination made with respect to the partner, shareholder, or beneficiary in connection with the same property.

(6) Example. Paragraphs (1) to (5) are illustrated as follows:

Example 1. General Facts. Corporation S, a calendar year S corporation, places in service on June 1, 1988, the following three items of eligible property:

Asset number	Basis
1	$30,000
2	$30,000
3	$30,000

On December 31, 1988, Corporation S has 200 shares of stock outstanding which are owned equally by shareholders A and B, calendar year taxpayers. The total basis of the three eligible properties are apportioned to shareholders A and B as follows:

Total basis $90,000
Shareholder A (100/200) .. $45,000
Shareholder B (100/200) .. $45,000

In taxable year 1988, each shareholder takes a credit of $450 ($15,000 x 3%) for each of the three eligible properties, or a total credit of $1,350 ($15,000 x 3% x 3).

Example 2. Assume the facts as in Example 1 and the following fact. On December 21, 1989, Corporation S sells asset No. 3 to Corporation X. For taxable year 1989, shareholders A and B must each recapture $297 ($450 x 66%) of their previously taken credit. Corporation X will not be subject to recapture because it never benefited from the credit.

Example 3. Assume the facts as in Example 1 and the following fact. On November 11, 1990, shareholder A sells 50 of A's 100 shares to C. As a result, 50 per cent of A's share of the basis of each of the three eligible properties cease to be eligible properties with respect to A since immediately after the sale, A's proportionate interest in Corporation S is reduced to 50 per cent of A's interest at the time the credit was taken. For taxable year 1990, A must recapture $222.75 ($1,350 x 50% x 33%).

Example 4. Assume the facts as in Examples 1 and 3, and the following fact. On September 1, 1991, shareholder A disposes of 10 more shares to E, leaving A with 40 of A's original 100 shares. The sale in 1991 does not trigger recapture for A because of the 33 1/3 per cent rule—since A was subject to recapture by reason of a reduction in interest below 66 2/3 per cent (i.e., 50 per cent) in 1990, A experiences no further recapture until A's interest is reduced to less than 33 1/3 per cent of A's original interest. The sale in 1991 reduces A's interest to only 40 per cent. E will not be subject to recapture.

Example 5. Assume the facts as in Example 1 and the following fact. On November 11, 1990, shareholder A sells 15 of A's 100 shares to D. The sale does not trigger recapture for A because of the 66 2/3 per cent rule—A's interest in Corporation S has not been reduced below 66 2/3 per cent of A's interest at the time the credit was taken. This result occurs despite the fact that A now owns only 85 per cent of A's original stock interest. D will not be subject to recapture.

(7) S corporation election.

(A) In general. If a C corporation makes a valid election under section 235-2.4, HRS, to be an S corporation, then on the last day of the taxable year immediately preceding the first taxable year for which the election is effective, any eligible property the basis of which was taken into account to compute the C corporation's credit allowable in taxable years prior to the first taxable year for which the election is effective (and which has not been disposed of or otherwise ceased to be eligible property with respect to the C corporation prior to such last day) shall be considered as having ceased to be eligible property with respect to the C corporation and the recapture rule shall apply. However, the recapture rule shall not apply if the S corporation and each of its shareholders on the first day of the first taxable year for which the election under section 235-2.4, HRS, is to be effective, or on the date of the election, whichever is later, execute an agreement as is described in subparagraph (B).

(B) "Agreement", defined. The agreement shall: (i) be signed by the shareholders; and on behalf of the S corporation by a person who is duly authorized; (ii) state that if eligible property for which the credit was taken is later disposed of by, or ceases to be eligible property with respect to the S corporation during the recapture period and during a taxable year for which the S election is effective, each signer agrees to notify the director of a disposition or cessation; and to be jointly and severally liable to pay the director an amount equal to the increase in tax provided by the recapture rule; (iii) state the name, address, and taxpayer identification number (e.g., social security number) of each party to the agreement; (iv) be filed with the department for the taxable year immediately preceding the first taxable year for which the S election is effective; and (v) be filed with the department on or before the due date (including extensions of time) of the return, unless the director permits, upon a showing of good cause, that the agreement may be filed on a later date.

(C) Shareholder's share of the amount of credit recapture. A shareholder's share of the amount of credit recapture shall be determined as if the property had ceased to be eligible property as of the last day of the taxable year immediately preceding the first taxable year for which the S election is effective; however, the recapture percentage shall be determined as if the property ceased to be eligible property on the date the property actually ceased to be eligible property.

(g) Transfer of eligible property out of Hawaii. During the recapture period, all or a portion of previously taken credit will be subject to recapture if the eligible property is transferred out of the State of Hawaii.

(h) Example. Subsection (g) is illustrated as follows:

X, a calendar-year taxpayer, places eligible property in service on September 1, 1988. The property has a basis of $10,000 and is used entirely for business purposes. X claims the credit on its 1988 tax return. On June 1, 1989, X transfers the eligible property out-of-state to another section of its business operation. The transfer of property out-of-state triggers recapture of the credit in taxable year 1989 of $300 [(10,000 x 3%) x 100%]. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-16 Exceptions to the recapture rule.** (a) Transfer by reason of death. A transfer by reason of death is not considered to be a disposition of eligible property, subject to the recapture rule. This exception to the recapture rule applies to transfers by reason of death of a sole proprietor, partner, S corporation shareholder, or beneficiary of an estate or trust.

(b) Example. Subsection (a) is illustrated as follows:

A, a calendar-year taxpayer, places in service in 1988, eligible property with a basis of $5,000. In 1988, A takes a credit in the amount of $150 ($5,000 x 3%). A dies in 1989, and the property is transferred to A's heir. In 1989, no credit is required to be recaptured. Further, the heir can immediately dispose of the property without the possibility of credit recapture.

(c) Transaction to which I.R.C. §381(a) applies. A disposition of eligible property in a transaction to which I.R.C. §381(a) (with respect to carryovers in certain corporate acquisitions) applies is not considered to be a disposition of eligible property, subject to the recapture rule. However, if the acquiring corporation disposes of the eligible property before the close of the recapture period, there will be an early disposition and the recapture rule will be triggered.

(d) Mere change in form of conducting a trade or business.

(1) In general. Recapture is not required as a result of a mere change in the form of conducting a trade or business if: (A) the property is retained as eligible property in the same trade or business; (B) the transferor (or in a case where the transferor is a partnership, estate or trust, or S corporation, the partner, beneficiary, or shareholder) of eligible property retains a substantial interest in the trade or business; (C) substantially all the property (whether or not eligible property) necessary to operate the trade or business is transferred in the change of form; and (D) the basis of eligible property in the hands of the transferee is determined in whole or in part by reference to the basis of eligible property in the hands of the transferor (i.e., carryover basis).

(2) Paragraph (1) shall not apply to the transfer of eligible property if I.R.C. §381 (regarding carryovers in certain corporate acquisitions) applies to the transfer.

(3) "Substantial interest", defined. For purposes of this exception, a transferor (or in a case where the transferor is a partnership, estate or trust, or S corporation, the partner, beneficiary, or shareholder) is considered to have retained a substantial interest in the trade or business if, after the change in form, the transferor's interest in the trade or business is: (A) substantial in relation to the total income interest of all the owners; or (B) equal to or greater than the transferor's interest prior to the change in form. A taxpayer will not be considered to have retained a substantial interest where the only basis for claiming substantial interest is that the values of the interests exchanged are equal.

(A) Examples. Paragraph (3) is illustrated as follows:

Example 1. A taxpayer owns a five per cent interest in a partnership. After an incorporation of the partnership, the taxpayer retains at least a five per cent interest in the corporation. In this case, the taxpayer will be considered to have retained a substantial interest in the business as of the date of the change in form.

Example 2. A taxpayer exchanges a 48 per cent partnership interest for a seven per cent interest in a corporation (seven per cent of the outstanding stock), contending that the values of the interests exchanged are equal. In this case, the taxpayer will not be considered to have retained a substantial interest.

(B) The determination of whether a taxpayer has retained a substantial interest in the trade or business is to be made immediately after the change in the form of conducting

the trade or business, and after each time the taxpayer disposes of a portion of the taxpayer's interest in the new enterprise.

(4) S Corporation. Neither an election to be treated as an S corporation, nor a termination or loss of S corporation status automatically triggers recapture. However, recapture may result if either of the recapture events discussed in paragraph (5) occurs. In determining whether a reduction in a shareholder's interest (for example, by a sale of stock) will result in recapture, the 66 2/3 per cent and 33 1/3 per cent rules (as discussed in section 18-235-110.7-15(f)) apply even if the corporation is no longer an S corporation.

(5) Disposition or cessation. Property ceases to be eligible property with respect to a transferor (or in a case where the transferor is a partnership, estate or trust, or S corporation, the partner, beneficiary, or shareholder), and the transferor must make a recapture determination if during the recapture period: (A) the transferee disposes of eligible property (or if eligible property otherwise ceases to be eligible property in the hands of the transferee); (B) the transferor (or in a case where the transferor is a partnership, estate or trust, or S corporation, the partner, beneficiary, or shareholder) does not retain a substantial interest in the trade or business directly or indirectly (through ownership in other entities provided that the other entities' bases in the interests are determined in whole or in part by reference to the bases of the interests in the hands of the transferor).

(6) Recordkeeping. A taxpayer who seeks to establish the taxpayer's interest in a trade or business under this subsection must maintain adequate records to demonstrate the taxpayer's direct or indirect interest, or both, in the trade or business after any transfer.

(e) Transfer between spouses or incident to divorce.

(1) In general. A transfer between spouses or incident to divorce is not considered to be a disposition, subject to the recapture rule.

(2) Subsequent to a transfer between spouses or incident to divorce, a disposition by the transferee during the recapture period may result in recapture to the same extent as if the disposition had been made by the transferor at that later date.

(3) Paragraphs (1) and (2) apply to transfers made after December 31, 1987, in taxable years ending after December 31, 1987. It does not apply to transfers under an instrument in effect before January 1, 1988.

(f) Property destroyed by casualty. The recapture rule shall not apply to eligible property which is disposed of or otherwise ceases to be eligible property with respect to the taxpayer as a result of its destruction or damage by fire, storm, shipwreck, or other casualty, or theft.

(g) Downward basis adjustment pursuant to I.R.C. §754 (regarding manner of electing optional adjustment to basis of partnership property). In the case of a partnership, a downward basis adjustment pursuant to I.R.C. §754 is not subject to recapture because the use of the property is not considered to be terminated for purposes of the credit. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-17 Recapture limitation.** An increase in income tax due to recapture is limited to the total credit claimed. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-18 Refund.** The credit is deductible from the taxpayer's net income tax liability for the year in which it qualifies. If the credit exceeds the taxpayer's net income tax liability, the excess of credit over liability shall be refunded to the taxpayer; however, no refund on account of the credit shall be made for an amount less than $1. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-19 Carryback and carryover of credit.** There shall be no carryback or carryover of excess credit over liability. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-20 Filing procedure.** (a) In general. A claim for the credit, including an amended claim, must be filed on or before the end of the twelfth month following the close of the taxable year for which the credit may be claimed, or if an extension of time for filing a return has been granted, within the extension period.

(b) Form. The claim for the credit shall be made on Form N-312. For recapture purposes, a recomputation of the credit shall be made on Part II of Form N-312.

(c) Failure to comply with filing requirements. A failure to comply with these filing requirements shall constitute a waiver of the right to claim the credit.

(d) Partner, S corporation shareholder, or beneficiary of an estate or trust. In the case of a taxpayer who is involved in a pass-through entity (i.e., partnership, S corporation, estate, or trust) and who claims a credit for the entity's eligible property, the taxpayer shall attach to Form N-312, a copy of the Schedule K-1 and any other statement (relating to the credit) which is provided by the pass-through entity. A copy of the Schedule K-1 and other statement

shall be attached to Form N-312 both when the credit is claimed, and when the credit is subject to recapture. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-21 Identification of property.** (a) In general. A taxpayer must maintain records from which the taxpayer can establish, with respect to each item of eligible property, the following facts:

(1) The month and the taxable year in which the property was placed in service;
(2) The basis of the property;
(3) The estimated useful life or recovery period that was assigned to the property to determine eligibility for the credit; and
(4) The date the property is disposed of or otherwise ceases to be eligible property.

The above stated facts will be analyzed to determine both the eligibility for the credit, and the necessity for any recapture of credit.

(b) Insufficient records. For recapture purposes, if the taxpayer's records are insufficient to establish the above stated facts, it will generally be assumed that the most recently acquired eligible property was disposed of first.

(c) Mass assets. Where the maintenance of records of details on mass assets is impractical, the taxpayer may adopt reasonable recordkeeping practices, consonant with good accounting practices and consistent with the taxpayer's prior recordkeeping practices. Mass assets means a mass or group of individual items of property (A) not necessarily homogeneous, (B) each of which is minor in value relative to the total value of the mass or group, (C) numerous in quantity, (D) usually accounted for only on a total dollar or quantity basis, and (E) with respect to which separate identification is impracticable. Examples include portable air and electric tools, jigs, and hardware.

(d) Taxpayer uses an averaging convention to compute depreciation for eligible property. A taxpayer's use of an averaging convention to compute depreciation for eligible property will be recognized to determine if recapture is required for a particular property.

(1) "Averaging convention", defined. The averaging convention provides for assumed dates that property is placed in service, or ceases to be eligible property. For example, it might be assumed that all additions and retirements made during the first half of a given year were made on the first day of that year, and that all additions and retirements during the second half of that year were made on the first day of the following year.
(2) The taxpayer must consistently use the assumed dates to compute the recapture of credit for all eligible property depreciated under the taxpayer's averaging convention. In any event, however, the director may disregard the taxpayer's use of the averaging convention dates if the use results in a substantial distortion of eligibility for the credit. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-110.7 **§18-235-110.7-22 Banks and other financial corporations.** Sections 18-235-110.7-01 to 18-235-110.7-21 shall apply to banks and other financial corporations. [Eff 1/18/90] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-110.7)

HRS §235-111 **§18-235-111 Limitation period for assessment, levy, collection, or credit.** (a) Tax imposed under chapter 235, HRS, shall be assessed or levied, and any overpayment shall be credited, within three years after filing the final income tax return for the taxable year, or within three years of the prescribed due date of the return, whichever is later.

(1) Running of the limitation period.
  (A) In general. Although returns may be filed before the prescribed due date, the running of the limitation period for purposes of section 235-111, HRS, and this section, unless otherwise prescribed, does not start until after the prescribed due date for filing.
  (B) Where an amended return is filed. When a return has been timely filed as required by law and thereafter an amended return is filed, the limitation period begins to run from the date the original return was filed or the prescribed due date, whichever is later. Filing an amended return does not extend, nor does it stop, the running of the limitation period. The original return, however, must be complete and meet the statutory requirements; the limitation period will begin to run only upon the filing of a proper return. The running of the limitation period is not affected or suspended by the later filing of amended returns.
  (C) Loss of S corporation status. Where corporate tax liability is found to be due upon a determination that the corporation is not entitled to the benefits of a corporation organized under subchapter S (sections 1361 to 1369) of the Internal Revenue Code of 1986, as amended, the limitation period for assessment and collection shall run from the date the return is filed or from the prescribed due date for filing the return, whichever is later.

(2) Credit resulting from net operating loss carrybacks. As set forth in section 235-111, HRS, the limitation period for credit related to an overpayment of tax resulting from a net operating loss carryback shall be the later of:

(A) Three years from the prescribed due date for filing the return for the taxable year in which the net operating loss occurs; or

(B) Any extension period, as agreed by the taxpayer and the department, pursuant to this section.

(b) This section does not bar assessment of tax, or a proceeding for collection without assessment, where no return is filed or where a false or fraudulent return is filed with the intent to evade tax liability.

(c) Extension by agreement. Form N-102 shall be used to extend the limitation period of income tax as prescribed in section 235-111(c), HRS, and must be signed by the taxpayer and the director of taxation or designee in the district in which the return is filed. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-111)

HRS §235-112 **§18-235-112 Time for assessment of deficiency attributable to gain upon conversion.** (a) (Reserved)

(b) Notification required by taxpayer. Notification pursuant to section 235-112(b), HRS, shall be made in a written statement attached to the taxpayer's income tax return for the taxable year or years in which the converted property is replaced, the intention not to replace the property is formed, or the period for replacement expires. The notification shall include all details related to the replacement of the converted property.

(c) Property not replaced, period for replacement expires. If the taxpayer does not replace and does not intend to replace the converted property within the required replacement period as set forth in section 1033(a)(2)(B), IRC, the taxpayer shall amend the tax return for the year in which the property was converted. The amended return shall be filed within the required replacement period. Any gain or loss on the conversion of the property shall be reported on the amended return, and any taxes owed shall be submitted at the time the amended return is filed.

(d) Limitation period. Pursuant to section 235-112(b), HRS, the department may assess any deficiency attributable to gain on the conversion of property within three years from the date the department is notified by the taxpayer that the converted property has been replaced or that the taxpayer does not intend to replace the converted property. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-112)

HRS §235-113 **§18-235-113 Time for assessment of deficiency attributable to gain upon sale of residence.** (a) (Reserved)

(b) Notification required by taxpayer. Notice to the department as required by section 235-113(b), HRS, shall be made in the taxpayer's tax return for the taxable year in which the gain from the sale of the principal residence is realized.

(c) Limitation period. Pursuant to section 235-113, HRS, the department may assess any deficiency attributable to any gain from the sale of property used as the taxpayer's principal residence as set forth in section 235-113(a), HRS. The deficiency shall be assessed within three years from the date the department is notified that the taxpayer has purchased replacement property, intends not to replace the property, or the period for replacement expires. [Eff 2/16/82; am 6/28/93] (Auth: HRS §§231-3(9), 235-118) (Imp: HRS §235-113)

§18-235-114 to 18-235-119 (Reserved)

HRS §235-122 **§18-235-122 S corporations; domestic and foreign.** (a) The definitions in section 18-235-4-01 apply to this section.

(b) A resident shareholder of an S corporation is subject to tax on the shareholder's pro rata share of the S corporation's income from whatever source derived.

(c) A nonresident shareholder of an S corporation is subject to tax on the shareholder's pro rata share of the S corporation's Hawaii source income.

(d) Shareholders of an S corporation shall be subject to tax on their pro rata shares of S corporation income whether or not the S corporation is required to file a return.

(e) An S corporation shall determine Hawaii source income by allocation and apportionment under the Uniform Division of Income for Tax Purposes Act, sections 235-21 to 235-39, HRS, if and to the extent that:

(1) The S corporation derives income from business activity both within and without this State,

(2) The S corporation's business activity is taxable in both this State and another jurisdiction, and

(3) The income is not derived from the rendering of purely personal services.

Otherwise, an S corporation shall determine Hawaii source income by allocation and separate accounting pursuant to section 235-5, HRS, and section 18-235-5-02. For an S corporation incorporated in Hawaii, Hawaii source income includes income that is allocated or apportioned to any jurisdiction in which the S corporation is not taxable.

(f) An S corporation return made pursuant to section 235-128, HRS, shall report the gross income, gains, losses, deductions, and credits from whatever source derived, and each shareholder's pro rata share of those items. The S corporation also shall report each shareholder's pro rata share of income, gains, losses, deductions, and credits from sources within the State. [Eff 9/3/94] (Auth: HRS §§231-3(9), §235-118) (Imp: HRS §235-4(d), 235-122)