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June 5, 2012

LETTER RULING 2012-08

[Redacted Text]
[Redacted Text]
[Redacted Text]
[Redacted Text]
[Redacted Text]

Re: Grandfathering Exception Provisions of Act 105, Session Laws of Hawaii 2011

Dear [Redacted Text]:

By letter dated December 28, 2011, [Redacted Text] (the "Taxpayer"), through its authorized representative, requested the State of Hawaii Department of Taxation (the "Department") rule on whether the temporary suspension of the subcontractor deduction under section 237-13(3)(B) of the Hawaii Revised Statutes ("HRS") provided in Act 105, Session Laws of Hawaii 2011 ("Act 105") applies to the government contract awarded to the Taxpayer on [Redacted Text] (the "Prime Contract"), and all task orders, change orders and subcontracts subsequently issued under the Prime Contract.

FACTS REPRESENTED BY THE TAXPAYER

The Taxpayer is a Hawaii general partnership with two partners, [Redacted Text]. The Taxpayer was organized to bid on and provide contracting services for [Redacted Text].

[Redacted Text].

The Contract [Redacted Text].

The Prime Contract states:

"This is a firm fixed-price contract, and subject to the provisions of this paragraph and in accordance with [the General Conditions], as amended by [the Special Provisions], [the City] agrees to pay the [Taxpayer], for the satisfactory performance and completion of the Work, the payments The lump sum payments for services and the Work performed under the Contract are all inclusive of direct labor, overhead, general and administrative expenses, other direct costs, subcontractor costs, fixed fees, and all applicable taxes, State general excise and use tax (GET) and

county one-half percent (0.5%) GET Surcharge.”

Under the Prime Contract, the Taxpayer intends to furnish to the City various items affixed to realty, including [Redacted Text]. The Taxpayer also intends to furnish various items not affixed to realty, such as [Redacted Text]. The Taxpayer further intends to subcontract a substantial portion of the work associated with the [Redacted Text] to, among others, its partners and/or their respective U.S. subsidiaries. The City may also issue separate task orders or change orders over the course of the contract period.

LAW AND ANALYSIS

HRS § 237-13(3)(B) allows a contractor to deduct from gross receipts, amounts paid to: (1) another contractor as defined in § 237-6, HRS, (2) a specialty contractor duly licensed by the Department of Commerce and Consumer Affairs (“DCCA”), and (3) a specialty contractor not licensed by the DCCA who performs contracting activities only on federal military installations.

Act 105, Session Laws of Hawaii 2011, temporarily suspends the exemptions for certain persons and certain amounts of gross income or proceeds from the general excise and use tax, and requires the payment of both taxes at a four per cent rate. One provision suspended by Act 105 is the subcontractor deduction under HRS § 237-13(3)(B). The suspension is effective for a two year period beginning July 1, 2011 and ending June 30, 2013.

However, Act 105 also created a “Grandfathering Exception” which states that the “[temporary suspension] shall not apply to gross income or gross proceeds from binding written contracts entered into prior to July 1, 2011, that do not permit the passing on of increased rates of taxes.”

The Department issued Department of Taxation Announcement (“Announcement”) Nos. 2011-09 and 2011-10 and Tax Information Release (“TIR”) 2011-02 to provide guidance regarding the application of the Grandfathering Exception. Announcement No. 2011-09 states that there are three elements that must be met in order for the Grandfathering Exception to apply: “First, the contract must not permit the increase in tax to be passed on to the consumer. Second, the contract must be in writing. Third, the contract must be binding prior to July 1, 2011.”

TIR 2011-02 provides the following additional guidance regarding application of the Grandfathering Exception to requests for proposals issued by a government agency:

Unlike bids in response to an invitation to bid, a proposal in response to a request for proposal issued by a local, state, or federal government will not be treated as a binding written contract. However, an award in response to a request for proposal will be treated as a binding written contract and will be grandfathered from the suspension of an exemption in Act 105, provided the award is made before July 1, 2011, and results in a fully executed contract.

First, as indicated by the provision of the Prime Contract quoted above, the Prime

Contract does not allow the Taxpayer to pass the increase in tax to the City because it is a fixed price contract inclusive of all taxes. If taxes were to increase, the Taxpayer would be responsible for such increase. Second, the Prime Contract is in writing and incorporates the Special Provisions and General Conditions which are also in writing.

Finally, in order for the Prime Contract to satisfy the Grandfathering Exception, it must have been binding prior to July 1, 2011 and result in a fully executed contract. The rules regarding request for proposals by a government agency outlined in TIR 2011-02 will determine the contract binding date in this situation. Here, the award in response to the request for proposal is dated **[before July 1, 2011]** and was followed by the execution of the Prime Contract dated **[Redacted Text]**. For the purpose of this analysis, the Prime Contract is considered binding as of **[before July 1, 2011]** and thus, satisfies the final requirement.

Because the three elements of the Grandfathering Exception are met, the temporary suspension of the subcontractor deduction under HRS § 237-13(3)(B) pursuant to Act 105 will not apply to the Prime Contract. Therefore, qualifying amounts paid to subcontractors under section 237-13(3)(B), HRS for work to be performed under the Prime Contract may be deducted by the Taxpayer.

Announcement No. 2011-10, states that if the increase in tax may not be passed on to the consumer, the contract is in writing, and the contract is binding before July 1, 2011:

[A]ny change orders relating to the original contract will be treated as entered into before July 1, 2011, as provided in Tax Announcement 2011-09. In addition, task orders will be treated like change orders. Like change orders and task orders, subcontracts by subcontractors of the general/prime contractor that are entered into after June 30, 2011, where the general/prime contractor fulfills the three conditions discussed above, will also be treated as entered into before July 1, 2011.

Because the Prime Contract satisfies the requirements of the Grandfathering Exemption, pursuant to Announcements No. 2011-09 and 2011-10, any task orders or change orders issued under or relating to the Prime Contract will be treated as entered into on **[before July 1, 2011]**.

In conclusion, based on the Taxpayer's representations, Act 105's temporary suspension of the subcontractor deduction under section 237-13(3)(B), HRS, does not apply to the Prime Contract, nor to all subsequent task orders, change orders and subcontracts thereunder. Therefore, the Taxpayer may claim the subcontract deduction under section 237-13(3)(B), HRS, with respect to subcontracts between the Taxpayer and others who qualify as contractors under section 237-6, HRS, entered into pursuant to the Prime Contract.

The ruling contained in this letter is based upon information and representations submitted by the Taxpayer and accompanied by penalty of perjury statements executed by appropriate parties. While this office has not verified any of the material submitted in support of

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the request for ruling, it is subject to verification on examination.

Except for the specific ruling above, we express or imply no opinion concerning the tax consequences of the facts of this case under any other provision.

The Taxpayer has reviewed the redacted version of this ruling and agreed that it will be available for public inspection and copying.

If you have any further questions regarding this matter, please call me at **[Redacted Text]**.

Sincerely,

TED S. SHIRAISHI
Administrative Rules Specialist