STATE OF HAWAII

DEPARTMENT OF TAXATION

General Excise Tax Memorandum No. 3

TO: ALL CONTRACTORS AND OTHER PERSONS WHO, AS A BUSINESS OR AS A PART OF A BUSINESS IN WHICH THEY ARE ENGAGED, CONSTRUCT BUILDINGS OR MAKE OTHER IMPROVEMENTS ON LAND HELD BY THEMSELVES IN FEE SIMPLE;

and

TO: ALL PERSONS WHO ENGAGE IN BUSINESS WHICH INVOLVES THE MAKING OR SALE OF LEASEHOLDS.

Subject: Imposition of General Excise Tax

PART I
GENERAL

Scope of this memorandum; provisions of law involved. This memorandum relates to the provisions of sections 3(a) and 3(n) of Act 1, Special Session Laws of 1957. Section 3(n) reads as follows: (now 237-13, paragraph D)

> "(n) Section 117-14 is amended by adding to subsection (c) a new paragraph to read as follows:
>
> "'(4) A person who, as a business or as a part of a business in which he is engaged, erects, constructs, or improves any building or structure, of any kind or description, or makes, constructs or improves any road, street, sidewalk, sewer or water system, or other improvements on land held by him (whether held as a leasehold, fee simple, or otherwise), shall upon the sale or other disposition of the land or improvements, even if the work was not done pursuant to a contract, be liable to the same tax as if engaged in the business of contracting, unless he shall show that at the time he was engaged in making such improvements it was, and for the period of at least one year after completion of the building, stricture or other improvements it continued to be, his purpose to hold and not to sell or otherwise dispose of the land or improvements. The tax in respect of such improvements shall be measured by the amount of the proceeds of such sale or other disposition that is attributable to the erection, construction or improvement of such building or structure, or the making, constructing or improving of such road, street, sidewalk, sewer or water system, or other improvements. The measure of tax in respect of the improvements shall not exceed the amount which would have been taxable had such work been performed by another, subject as in other cases to the deductions allowed by paragraph (2) of this subsection. Upon the election of the taxpayer this paragraph may be applied notwithstanding

the improvements were not made by the taxpayer, or were not made as or as a part of a business, or were made with the intention of holding the same. However, this paragraph shall not apply in respect of any proceeds that constitute or are in the nature of rent; all such gross income shall be taxable under subsection (h).'"

Section 20(d) of Act 1 provides that this provision: "shall not, except upon the election of the taxpayer, apply to any work done under a building permit issued prior to May 1, 1957, or to any gross income derived from a sale or other disposition actually and finally agreed upon prior to May 1, 1957, but the burden shall be upon the person claiming the benefit of this sub-section to show his compliance therewith."

Section 3(a) amends the exemption (section 117-3), which formerly read: "gross receipts from the sale of ** stocks or from the sale of real property", to read:

"gross receipts from the sale of ** stocks or, except as otherwise provided, from the sale of land in fee simple, improved or un-improved**".

What persons are affected. The persons affected by the quoted law are both those who sell fee simple land and those who make or sell leaseholds.

As to sales of fee simple land the persons affected are, in general, those who make improvements on their own land, without hiring a licensed contractor, or who hire a licensed contractor for only part of the work. A typical case is that of a landowner who himself is a contractor. If all the work is contracted out to another who is a licensed contractor and pays the tax on the contracting business so done by him, when the property afterward is sold there is no tax on the sales proceeds. However, if the work is parceled out among a number of contractors in such a manner that the project owner occupies a position equivalent to that of a general contractor, there generally will be a tax to be paid on the proceeds attributable to the improvement. The taxable amount will be reduced by deductions allowed for the amounts on which the contractors who occupy the position of sub-contractors are taxed, as stated in Part II.

As to the making and selling of leaseholds, if the land has been developed or improved it may well be that some portion of the proceeds is deductible by reason of the quoted law. Any person who considers the possibility of claiming such a deduction should acquaint himself with the principles involved. Leaseholds also are affected by reason of the fact that, under certain circumstances, the making of improvements is taxable upon the disposition of the improvements, thus eliminating, in such circumstances, the question whether the sale of the leasehold in itself is "business". See Part III.

The following persons are not affected by the quoted law, if the property is fee simple property or is a leasehold the sale of which does not constitute "business":

Those whose construction activities are not in the course of a business.

Those who build for rental purposes or with the intention of holding the property (unless there is a change of purpose within the year).

Those who sell property on which the improvements are just the same as those on the property when it was acquired.

It should be noted that the furnishing of equipment which is not installed as a part of the structure is, and always has been, a sale of tangible personal property by the supplier, contractor or project owner, as the case may be. The quoted law does not change this.

When the tax is due. No tax is due prior to sale or other disposition of the property. The tax applies as the price is received if the taxpayer is on the cash basis, or at the time of sale if the taxpayer is on the accrual basis.

PART II
FEE SIMPLE PROPERTY

Upon the sale of fee simple land by one who has made improvements in such a way as to be affected by the quoted law (see Part I), the measure of the tax is the lower of these two amounts:

(a) The amount of sales proceeds attributable to the improvements,

or

(b) The amount which would have been taxable as contracting business of a licensed contractor if the work had been contracted out in the usual manner.

As to any work contracted out, the amount on which tax was paid by that contractor may be deducted from the tax base in determining the tax, the same as is done by a general contractor having subcontractors.

PART III
LEASEHOLDS

In some instances the sale of a leasehold does not constitute "business" (for example, an isolated sale of a home situated on leasehold property), and in such instances the sales proceeds may be accounted for simply on the ground that the improvements, if any, made by the seller while he held the property were not made in the course of a business, or were made by a licensed contractor, or were made with the intention of holding the property which purpose continued for at least one year.

When a leasehold is made, or when the sale of a leasehold constitutes "business", all of the proceeds are taxable with the possible exception of those attributable to the sale or other disposition of the improvements.

For example, the tax always applies to a premium attributable to a rise in land values, which represents the difference between the ground rent stipulated in the lease and that which would be commandcd at the time of sale.

As used herein the expression “sales proceeds attributable to the improvements” does not signify any proceeds that constitute or are in the nature of rent.

The amount of sales proceeds attributable to the improvements is subject to reduction, as to the taxable amount, in the following manner: By showing, if lower than the amount of sales proceeds attributable to the improvements, the amount which would have been taxable as contracting business of a licensed contractor if the work had been contracted out in the usual manner, and by deducting from this amount any amounts as to which it is claimed that licensed contractors have paid the tax, or that persons taxable as contractors (for example, land developers) have paid the tax. The balance constitutes the tax base so far as the amount of sales proceeds attributable to the improvements is concerned.

If all of the improvements were made by a licensed contractor in the usual manner the entire amount of sales proceeds attributable to the improvements may be deducted on that ground.

The deduction always are subject to the required tax having in fact been paid by others.

PART IV
METHOD OF REPORTING AND MAKING RETURNS

Every licensee making a sale of fee simple land, and every licensee making or selling a leasehold who claims that any amount of the proceeds is deductible or non-taxable, must attach to the first return relating to the particular project answers to a questionnaire, the form of which will be supplied by the Tax Office. This questionnaire is to furnish the information set out below under the heading: “Questionnaire A.” In addition, if there are any “yes” answers to this questionnaire, unless the filing of further data is excused by the Director on the basis of the answers furnished, the taxpayer is to attach to the first return of payments from or sales of a given project a schedule showing the amount of tax returned and to be returned as computed by him for that project, and just how the amount has been computed for the project as a whole and also how the amount presently returnable has been determined. On subsequent returns relating to the same project reference should be made to the questionnaire and this schedule and to the time of filing them, unless other copies are attached, and the amount returned on the subsequent returns should be tied in to the initial schedule and questionnaire.

The information celled for by Questionnaire B must be available in the records of the person filing the return, and upon demand of the Director answers to this questionnaire, or portions of it as designated by the Director, must be furnished as a supplementary return and special statement under section 121-36, made applicable to the general excise tax law by section 117-9.

Questionnaire A

(To be answered by persons selling fee simple land, and by persons making or selling a leasehold who claim that any amount of the proceeds is deductible or non-taxable.)

1. Location and area of the project; date of the sale or other disposition of the property; whether the sale was of the fee simple; if a leasehold, date of the lease, name of lessor, ground rent provided for by the lease.

2. Did the person making the return, as a business or as a part of a business in which he was engaged, make improvements on the property without hiring a licensed contractor for the job, or by hiring a licensed contractor for only part of the job, or by parceling out the job among a number of contractors?

3. If the answer to No. 2 is “yes”, when were these improvements made?

4. If the answer to No. 2 is “yes”, what was the purpose in making the improvements?

5. If it is stated in answer to No. 4 that the purpose was to hold the property, when did a change of purpose occur?

6. If the making or sale of a leasehold is involved, does the person making the return claim that any amount of the proceeds is deductible or non-taxable? Why?

7. If the making or sale of a leasehold is involved, does the person making the return elect to have paragraph (4) of section 117-14(c) of the General Excise Tax Law apply? (now paragraph (D) of section 237-13 (3))

Questionnaire B

(To be filled out, upon demand of the Director, in whole or in part as designated by the Director.)

(a) Roads or streets, sidewalks, sewers or water systems, driveways, and other iprovements to land, except buildings, made or constructed as a part of the project. (In the case of leasehold property, designate also improvements of this type made by a previous developer.)

(b) To what extent, if any, were the improvements listed in (a) contracted out and performed by a licensed contractor who, it is claimed, paid the general excise tax on this contracting business. (In the case of leasehold property designate also improvements of this type on which it is claimed a previous developer paid the same tax as a licensed contractor.)

(c) As to any improvements listed in (a), that were not contracted out or made as explained in (b), a description of them giving square feet or cubic feet, type of materials and construction, and cost of each.

(d) Number of buildings constructed and for what purpose (e.g. number of houses, garages etc.); for each type of building, statement as to class of construction, type of materials, and floor areas with attached blue print.

(e) For each unit constituting a sales unit a description stating land area and buildings; floor area and number of floors of each class of construction and type; fixtures and equipment included; additional facilities included in the sales price, such as parking space, use of lobby, elevators, hallways etc.; also total number of sales units.

(f) Cost of construction for each type of building, segregated between material and labor; sources of supply for materials (named companies); cost of fixtures and equipment.

(g) Sales proceeds, per unit, and opinion of taxpayer as to proper division of this amount of sales proceeds between (1) raw land; (2) improvements listed in (a); (3) buildings, fixtures and equipment.

(h) Dates of commencement and completion of the project.

(i) If sale is on agreement of sale, outline of sales plan, as to down payments, installments, rate of interest, etc.

(j) Name of financial institution handling loans, if any.

(k) Names of contractors on the project and, for each, the subject matter of his contract and the amount on which it is claimed that tax has been paid by him.

Originally Issued: August 2, 1957
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EARL W. FASE, Director of Taxation

G. E. Memo. No. 3a

July 30, 1957

TO: Honorable Earl W. Fase

FROM: Attorney General's Department

Attention: Mr. J. A. Bell

This concerns questions raised by persons attending the meetings on June 24 and 28, 1957. These meetings were held for discussion of a preliminary draft of memorandum "To all contractors and other persons who, as a business or as a part of a business in which they are engaged, construct buildings or make other improvements on land held by themselves (leasehold or fee simple property).

Q. 1. What is meant by the reference on page 2 to the "furnishing of equipment which is not installed as part of the structure"?

Comment. This refers to items such as stoves or refrigerators, furnished the supplier to the person erecting the project.

If the person erecting the project is a licensed contractor who has included the stoves and refrigerators in the contract price, and title passes from the supplier to the contractor and then again from the contractor to the property owner, this is a sale at wholesale on the part of the supplier. Even though the stoves and refrigerators remain "tangible personal property" throughout, and are not deemed part of the structure or an installation therein, this is a sale by the supplier to a licensed seller, namely the contractor.

In the case of a sale by the supplier to a person erecting the project who himself is the property owner, holding the site either as fee simple property or as a leasehold, it is necessary for the supplier to ascertain whether the project owner buying this equipment is going to sell the property, including the equipment, or is going to hold it.

If the project owner is going to sell the property, there will be a 3½% tax on the project owner when he does so, upon his sale of tangible personal property, that is the stoves and refrigerators. This liability on the part of the project owner exists and has existed right along; such liability is not dependent upon the application of the new Section 117-14 (C)(4). In this case the supplier's sale is "at wholesale".

If the project owner is not going to sell the property, this is a 3½% sale upon the part of the supplier. Should the project owner, after renting the property or putting it to some other use thereafter sells it, this would not change the rate of tax upon the supplier.

Q. 2. In the case of a supplier selling building materials to a project owner who intends to continue to hold the property, for example, for rental purposes, at what point can the project owner make the election referred to at the end of Section 117-14(c)(4)? How is the supplier to determine the rate of tax on the sale of the building materials?

Comment. The election referred to at the end of Section 117-14(c)(4) is not made until the sale of the property by the project owner. (In the case of a project on leasehold property, such election may be advantageous to the project owner as noted below in the comment on the next question.) So far as the supplier is concerned he determines the rate of tax according to whether the purchaser does or does not intend to sell the property or dispose of the improvements at the time of purchase of the building materials.

Should the purchaser of the building materials say that he intends to sell the property but not sell it, the supplier of the building materials might be assessed an additional tax to bring the tax on the sale of the building materials to the 3½% rate. The supplier of the building materials then would have recourse against the purchaser of the materials if the supplier had taken a resale certificate.

Q. 3. When would it be advantageous for a property owner to make the election permitted by Section 117-14(c)(4)? Would such an election be advantageous in the case of a project situated on leasehold property, if the sales price included a profit on the improvements and the improvements had not depreciated in value?

Comment. As background for discussion of this point it is necessary to bear in mind that Section 117-(3), as amended, does not exempt gross receipts from the sale of leaseholds. The amended law is the same in this respect as the law before the 1957 amendment, that is, the sale of a leasehold in itself is taxable if constituting “business”. However, by making the election above referred to, the leaseholder making the sale can reduce the amount of tax in most cases. This comes about as follows:

Under Section 117-14(c)(4), if applicable under the circumstances or by reason of an election, the amount of the sales proceeds attributable to the improvements is not necessarily altogether taxed. If the amount of the sales proceeds attributable to the improvements exceeds the amount which would have been taxed to a licensed contractor erecting or making the improvements, the excess is not taxed. Or if the leaseholder making the sale can show that in fact a licensed contractor already has paid the tax upon the performance of the work on the improvements, there is no tax on the amount of sales proceeds attributable to the improvements. Thus, if the work was performed in the first place by a licensed contractor who paid the tax on the work, it would be advantageous to the leaseholder selling the improvements to make the election even though the improvements had depreciated and the amount of sales proceeds attributable to the improvements was less than the amount representing the contract job in the first place.

The foregoing are examples. The property owner making the sale will determine for himself from the combination of circumstances in the particular case what is to his advantage.

Q. 4. How does the tax apply to the premium in the following three instances?

A. An estate, owning a fee simple, makes a contract in order to have put in the streets, water connections etc., and then offers leaseholds, setting the ground rent on the basis of the improved lend. A few of the

lots do not sell for a considerable period, or perhaps having been sold are turned back and new leases issued by the fee simple owner. During this lapse of time there has been an upward trend in land values, and if the fee simple owner were setting the ground rents at this later time they would be higher. Accordingly the fee simple owner requires the payment of a premium by persons taking leases at this later time.

Comment. The proceeds derived from the making of a lease are, in general, taxable except as the taxable amount is reduced by application of the election permitted by Section 117-14(c)(4). This is true because Section 117-(3) as amended only exempts "the sale of land in fee simple, improved or unimproved".

In this case the premium represents the difference between the specified and the attainable ground rent for the term of the lease, discounted to the present day and paid in a lump sum. Section 117-14(c)(4) specifically says that the paragraph does not apply "in respect of any proceeds that constitute or are in the nature of rent." The tax applies to this premium.

A-1. In the situation already stated, the person taking the lease is a contractor builder who has a number of lots on which he builds and later sells by assigning the lease. The question arises as to whether the portion of the sales proceeds charged in order to recover the premium paid for the lease may be deducted by this contractor builder from his sales proceeds.

Comment. There is no deduction for this premium. This resembles the case of a monthly rent received from a sublessee, all of which is taxable without any deduction for the rent which the sublessor pays under the master lease.

B. An estate, the owner of the fee simple, sets the ground rent on the basis of the raw land. A developer puts in the streets, water connections etc. He contracts to do this but without any obligation on the part of the fee simple owner to pay him for the work. A lease is made to a lessee who intends to himself have a home built by a contractor in the usual manner. In order to obtain the lot, this person enters into a lease in which the ground rent represents the raw land, as above stated, and he also pays the developer the sum of $2,500,00, which represents a proportionate part of the improvements made by the developer, with a profit for the developer.

Comment. The developer is viewed as a "licensed contractor" putting in the street Improvements and the like under a contract with the estate which owns the fee simple. The developer is taxable on the entire proceeds even though paid to him by the lot purchaser.

B-1. The facts are as stated in B except that the lessee is a contractor builder who buys this lease, together with other leases, in order to put houses on the lots and sell the same by assigning the leases. He receives $16,500.00, $2,500.00 being recovery of the payment to the developer and $14,000.00 being for the house. May he deduct the $2,500.00 from his sales proceeds?

Comment. Yes, in this case the deduction may be taken because the $2,500.00 represents a portion of the sales proceeds attributable to improvements upon which the tax already has been paid. That is, it was paid by the original developer. This is not a premium that is in the nature of rent.

C. An estate is the owner of the fee simple. The estate fixes the ground rent on the basis of the improved land, contracting in the usual manner for the street improvements and other improvements to the land. The lessee taking the original lease is a contractor builder who has a number of such lots on which he builds himself, and afterwards sells them by assigning the leases. During the interval of time between his obtaining of the lease and the sale, the land values in the area have increased, and if a lease were made at this time it would command a higher ground rent. In making the sale this is considered. A part of the sales proceeds represents a premium, which is the amount of the difference, for the remainder of the term of the lease, between the ground rent fixed in the lease and what would be commanded at the present time, discounted to the present time and computed in a lump sum. Can the contractor builder deduct this portion of the sales proceeds in computing his tax?

Comment. No. he may not deduct this for the reasons stated in the comment on A, and A-1.

Q. 5. In the case of a fee simple owner who claims that the entire amount of the sales proceeds is exempt, for example on the ground that the improvements, though made by himself, were made with the intention of holding the property, which intention continued for a period ofat least one year after the completion of the improvements, what proof is required?

Comment. A form of questionnaire will be prepared so as to set out questions having to do with claims of exemption by fee simple owners upon the sale of the property. The answers to this questionnaire will constitute part of the taxpayer's return, and the penalties provided by law concerning information supplied on a return (Section 115-38) will apply. It will not be necessary to make an affidavit.

Q. 6. Will there be instances in which it is of advantage for a person selling a leasehold to compute "(a) the amount of sales proceeds attributable to the improvements", or "(b) the amount which would have been taxable as contracting business of a licensed contractor if the work had been contracted out in the usual manner." Will not the seller of a leasehold simply deduct the amount on which the tax has been paid by the contractor that he employs?

Comment. Even if the seller of the leasehold only seeks to deduct the amount on which the contractor has paid the tax, that deduction cannot exceed "the amount of sales proceeds attributable to the improvements," so in every case it will be necessary for a person selling a leasehold to determine that amount if he claims any deduction at all. Then, if that amount is in excess of "the amount which would have been taxable as contracting business of a licensed contractor if the work had been contracted out in the usual manner," it will be advantageous to the seller of the leasehold to show the latter figure.

Q. 7. What is the significance of information to be furnished by the taxpayer as to the sales plan, down payments and installments, rate of interest, etc.?

Comment. This is significant only in the case of a sale made under an agreement of sale. It is necessary to determine what part of the total payments constitutes interest. Interest always is taxable.

Q. 8. Assume a contractor builder who is erecting houses on his own property plans to sell each house and lot for $15,000.00. He arranges financing. Under these arrangements a $10,000.00 mortgage loan is made to the buyer at a discount payable by the builder in the amount of 3%. The buyer makes a down payment of $5,000.00. Of the remaining $10,000.00 the builder receives from the mortgage company $9,700.00, the balance of $300.00 being the 3% discount which is paid by the builder in order to obtain financing. Is this $300.00 deductible from the sales proceeds?

Comment. The $300.00 is part of the sales proceeds attributable to the improvements, but of that amount the taxable amount can not exceed "the amount which would have been taxable as contracting business of a licensed contractor if the work had been contracted out in the usual manner." The computation of this last amount will exclude the $300.00 and in that sense the $300.00 is deductible.

Respectfully,

(S) Rhoda V. Lewis

RHODA V. LEWIS
Deputy Attorney General