



DEPARTMENT OF TAXATION

STATE OF HAWAII
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RE: Application of the General Excise Tax to Interest Income

Advice has been requested as to the application of the general excise tax to interest income received by taxpayers from various sources and activities.

Section 237-13, HRS, provides that there is levied and shall be assessed and collected "privilege taxes against persons on account of their business and other activities in the state --."

Section 237-2, HRS, defines "business" or "engaging". in business to include all activities (personal, professional, or corporate), engaged in or caused to be engaged in with the object of gain or economic benefit either direct or indirect, but does not include casual sales.

Section 237-3, HRS, defines "gross income" to mean the gross receipts, cash or accrued, of the taxpayer received as compensation for personal services and the gross receipts of the taxpayer derived from trade, business, commerce, or sales and the value proceeding or accruing from the sale of tangible personal property, or service, or both, and all receipts, actual or accrued as hereinafter provided, by reason of the investment of the capital of the business engaged in, including interest, discount, rentals, royalties, fees and the like.

In general, all gross income from "engaging in business" or "business income" are subject to the general excise tax. "Business income" means income arising from transactions and activities in the ordinary course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's ordinary trade or business operations.

Similarly, interest income is business income subject to the general excise tax where it arises out of or was derived in the ordinary course of the taxpayer's trade or business or where the purpose for acquiring and holding the intangible is related to or incidental to such trade or business operations.

Business entities, such as corporations, partnerships, joint ventures, sole proprietorships, are generally created for the purpose of making profits, and practically all interest income earned by such business entities are considered

business income subject to the general excise tax. It is only when interest income is earned by an individual on his personal savings account, if such individual is not engaged in any trade or business, that the income is considered exempt; the theory being that the individual is not engaged in business when he merely makes deposits in his personal savings account for safekeeping purposes.

Some specific situations with corresponding conclusions are presented below to exemplify the circumstances under which interest may or may not be subject to the general excise tax.

Taxable Situations

Example 1

"A," an individual, receives rental income from a 20-unit apartment situated on a fee simple property and upon which income the general excise tax was reported and paid. In 1972, due to his failing health, "A" sold the entire 20-unit apartment on an agreement of sale.

The interest received under the agreement of sale is subject to tax as the interest thus received is deemed to be earned by reason of the investment of the capital of the business in which engaged (rental of the apartments) as provided in section 237-3.

Example 2

"B" operates a soda fountain as a sole proprietor. In addition to this business income, he derives other income from actively trading stocks which are purchased by the use of the funds from his business. The profits from his business, together with the proceeds from the sales of stocks, are deposited in a savings account at a bank. In 1972, "B" remodeled his business premises and dipped into this savings account for the necessary payment. Furthermore, he consistently relies on this savings account as a source of fund to supplement the financial needs of his business.

Since "B" is engaged in business, as defined in section 237-2, the interest earned on the deposits of the profits from his business is subject to tax by reason of his investing the capital of the business. As to the interest earned on the deposits of the proceeds from the sales of stocks, it too is subject to tax because such proceeds are used in the business.

Notwithstanding the foregoing, the general excise tax shall not be imposed on the interest earned on the deposits of the proceeds from the sales of stocks if "B" can prove to the satisfaction of the Director of Taxation that such sales proceeds are clearly segregated from the profits of his business and are deposited in a personal savings account and are not used to supplement the financial needs of his business.

Example 3

A group of individuals formed an investment club for the purpose of purchasing common stocks. Initially, each member was required to invest \$1,000; thereafter, each member paid in an additional \$10 each month. In the interim, the amounts thus pooled were deposited in a savings and loan

institution. which paid 5% interest. As sufficient cash was accumulated, withdrawals were made to purchase the common stocks. Any dividends from the stocks as well as the gross proceeds from the sale of the stocks were also deposited in this savings account. At the end of the year, interest in the amount of \$250 was credited to the club's savings account.

As defined in section 237-2, the club is deemed to be engaged in business since it was formed with "--the object of gain or economic benefit either direct or indirect--;" consequently, the interest is subject to the general excise tax.

Example 4

"C" Corporation operates a department store. For the convenience of its many charge customers, "C" Corporation has a 30-day charge plan as well as a revolving charge plan. If the amount due on the 30-day charge plan is delinquent, a service charge in the form of interest at the rate of 1/2% on the previous month's balance is added to the account. A similar procedure is followed with respect to the revolving charge plan.

The interest received from the foregoing source is subject to tax since such interest is earned in the regular course of the business.

Example 5

"D" Corporation is engaged in the business of acquiring, holding and selling real property in Hawaii. During 1972, it sold to purchasers on the mainland fee simple Hawaii land on agreements of sales in the ordinary course of its business.

The interest earned on the agreements of sales is deemed gross income of the business as defined in section 237-2 because the sales originate from real property situated in Hawaii. The foregoing principle is applicable notwithstanding the agreements of sales are executed outside of Hawaii and the transactions involve persons who are not residents of Hawaii.

Although section 237-3 excludes gross income derived from the sale of land in fee, "D" Corporation cannot contend that the interest arising from such agreements of sales is also excludable. The interest arises not from the sale of the land, but rather as a charge for the use of money. "D" Corporation is investing its money (business income), getting back the sum lent plus a return in the form of interest.

Example 6

Realty Associates, a registered partnership, was formed solely for the purpose of purchasing certain real property in Hawaii as an investment. No other properties were sold in Hawaii and no improvements were made on the said property purchased by this partnership. Subsequently, the real property was sold on installment.

The interest received by the partnership under the installment sale constitutes gross income within the meaning of section 237-3; it is a return on investment of the partnership's business; therefore, the interest is subject to tax. As was held in the previous example, the interest received on an agreement of sale arises not from the sale but as a charge for the use of the unpaid portion of the sale price.

Example 7

XYZ Memorial Park, Ltd., a profit cemetery company, is engaged in the business of selling cemetery plots, crypts and niches. A percentage of the selling price of the cemetery plots, crypts and niches is set aside for a perpetual care fund, the income from which is applied to the perpetual care and maintenance of the cemetery plots, crypts and niches. The fund is turned over to XYZ Memorial Park Association, a nonprofit organization composed of purchasers of the cemetery plots, crypts and niches in the memorial park. XYZ Memorial Park Association invests the perpetual care fund in corporate and governmental bonds receiving interest thereon.

The interest income received by XYZ Memorial Park Association is subject to the general excise tax, notwithstanding the fact that it is a nonprofit organization, on the premise that the perpetual care fund provides an essential part of the function of the cemetery company itself. Where the company actually operating the cemetery is itself a profit-making enterprise, the perpetual care fund operated in connection with it would also partake of this character and the interest income thus received is subject to tax. Furthermore, as the services and facilities furnished by a perpetual care fund to a cemetery operated for profit constitute substantial assistance in its business by affecting the salability and selling price of lots, and relieving the company itself of a legal or contractual obligation, net earnings of such funds inure to the benefit of the profit company or its stockholders.

Nontaxable Situations

Example 1

"E," an individual, sells his automobile for \$1,000. He uses his automobile primarily for commuting to and from work and for other personal purposes. He deposits the proceeds from this sale in his savings account which is maintained for depositing a part of his monthly salary.

Notwithstanding the fact that "E" has made a sale of property and deposited some or all of the money so received, the interest earned hereon is not subject to tax because he is not deemed to be in "business" or "engaging" in business as provided in section 237-2.

Example 2

"F," an employee of Alpha Corporation, sold his residence situated on Kauai because he was to be relocated to a new jobsite in Honolulu. He executed an agreement of sale for a term of five years with interest at the rate of 8% per annum.

The interest received on the agreement of sale does not constitute "gross income" as defined in section 237-3 nor does the transaction involve "engaging" in business as provided under section 237-2. Consequently, the interest received in this situation is not subject to the tax.

Example 3

Peter, Paul and Mary Singers inherited from their father a large parcel of unimproved land situated in Hawaii. The property was held jointly for several years, without producing any income therefrom, after which it was sold on an agreement of sale.

The interest received under the agreement of sale is not subject to tax since the acquisition and subsequent joint ownership of the property were for purposes other than of acquiring, using, holding and leasing real property for the production of income.

However, if the Singers leased the real property prior to the sale whereby income attributable to the lease was earned, the interest received on the agreement of sale is subject to tax as provided under section 237-2 on the premise that the Singers were engaged in business.

Example 4

"G" Corporation, a local development company qualifying for loans under section 502 of the Small Business Investment Act of 1958, as amended, applies for and obtains a loan of \$100,000 through the Small Business Administration at an interest rate of 5%. It lends \$25,000 of the funds so obtained through the SBA to Fred Carpenter at the same interest rate of 5%. Mr. Carpenter will use the loan for purposes of establishing himself in a retail drug business.

"G" Corporation is exempted from the general excise tax relative to the interest earned on this type of loan as provided in section 237-23(15), since the interest on its loan to be repaid to the SBA and the interest to be received from Mr. Carpenter are at the same rate; otherwise, the exemption as provided in section 237-23(15) will not be applicable.

Example 5

ABC Lodge (an exempt organization as provided in section 237-23(a)(5)) deposits in a savings account monies it receives from contributions, donations, and dues as well as from the sale of the lodge's real property. Interest in the amount of \$1,500 was credited to this savings account at the end of the year. This organization does not receive income other than from the foregoing sources.

The contributions, donations, and dues received by the organization as well as the proceeds from the sale of the property which are deposited in the bank do not constitute "investment of the capital of the business in which engaged." The interest received is deemed incidental to the primary purpose of depositing the monies in the bank--that of safekeeping such funds; consequently, the interest is not subject to tax.

Example 6

ABC Cemetery Park, Inc., a nonprofit cemetery company, is engaged in the cemetery business which qualifies for the general excise tax exemption as provided under section 237-23(a)(12). Included in the selling price of the cemetery plots, crypts and niches is an amount for a perpetual care fund, the income from which the company applies to the perpetual care and maintenance of the cemetery plots, crypts and niches. ABC Cemetery Park, Inc., invests the fund in corporate and governmental bonds receiving interest income thereon.

The interest income received by ABC Cemetery Park, Inc., is not subject to the general excise tax inasmuch as the overall activity of ABC Cemetery Park, Inc., is deemed to be in the establishment and conduct of a cemetery, no part of the net earnings of which inures to the financial benefit of any private stockholder or individual.

In conclusion, the determination as whether interest income is subject to the general excise tax must be based upon an independent review of the facts in each situation. If the interest income is business income as described in this memorandum, such interest income is subject to the general excise tax.

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