



DEPARTMENT OF TAXATION

STATE OF HAWAII

September 14, 1988

TAX INFORMATION RELEASE No. 88-6

RE: Capital Goods Excise Tax Credit

Throughout this Tax Information Release ("TIR"), reference is made to the "Code." Unless otherwise stated, a reference to the Code 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.

Although certain investment tax credit ("ITC") definitions are adopted, for purposes of the capital goods excise tax credit ("credit"), ITC principles do not dictate the availability of the credit.

I. CAPITAL GOODS EXCISE TAX CREDIT LAW GENERALLY

Effective January 1, 1988, there shall be allowed to each taxpayer subject to the tax imposed by chapter 235 Hawaii Revised Statutes ("HRS"), a credit if:

- (1) The taxpayer purchases or imports section 38 property, new section 38 property, or used section 38 property. The terms section 38 property, new section 38 property, and used section 38 property are defined in section V of this TIR. Hereinafter, unless otherwise stated, the terms section 38 property, new section 38 property, or used section 38 property are referred to as 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 chapter 237 or 238, HRS;
- (3) The eligible property is used by the taxpayer in a trade or business;
- (4) The eligible property is purchased and placed in service within Hawaii after December 31, 1987; 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.

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. There shall be no carryback or carryover of excess credit over liability.

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. An extension of time for filing a return does not extend the time for claiming the credit. The claim for the credit shall be made on Form N-312 which is provided by the Department of Taxation of the State of Hawaii ("Department"). Failure to comply with these filing requirements shall constitute a waiver of the right to claim the credit.

II. PURCHASED AND PLACED IN SERVICE WITHIN HAWAII AFTER DECEMBER 31, 1987

A. In General

The credit may be claimed with respect to eligible property only in the first taxable year in which the property is purchased and placed in service within Hawaii.

The phrase "purchased and placed in service" means the date the property is acquired, available, or ready for use, whichever is earlier.

B. Purchase

A purchase means an acquisition of property, provided it is not acquired in a related-party transaction (as defined in Code section 179(d)(2)(A) or (B)).

C. Placed In Service

The term "placed in service" is the earlier of the following taxable years:

- (1) The taxable year in which the period for depreciation with respect to the property begins or the taxable year in which under the Accelerated Cost Recovery System ("ACRS") a claim for recovery allowances with respect to the property begins; or
- (2) 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.

Equipment acquired for a specifically assigned function for the taxpayer and which is operational is considered to be placed in service even though it may be undergoing testing to eliminate defects.

D. Examples

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. Assuming that the property is used 100 per cent for business purposes and otherwise qualifies for the credit, the entire basis shall be considered in 1988 to determine the amount of credit allowable.

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. Assuming that the property is used 100 per cent for business purposes and otherwise qualifies for the credit, the entire basis shall be considered in 1988 to determine the amount of credit allowable.

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. Assuming that the property is used 100 per cent for business purposes and otherwise qualifies for the credit, the entire basis shall be considered in 1988 to determine the amount of credit allowable.

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. Assuming that the property is used 100 per cent for business purposes and otherwise qualifies for the credit, the entire basis shall be considered in 1988 to determine the amount of credit allowable.

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. Assuming that the property is used 100 per cent for business purposes and otherwise qualifies for the credit, the entire basis shall be considered in 1988 to determine the amount of credit allowable.

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.

E. Sale-Leaseback

A special rule applies to determine when property is purchased and placed in service in a sale-leaseback situation. A sale-leaseback situation is a transaction in which section 38 property is originally purchased and placed in service by a taxpayer, and is sold and leased back by that same taxpayer, or is leased to that same taxpayer, within three months after the date the property was originally purchased and placed in service. In the case of a sale-leaseback, the property shall be considered to be purchased and placed in service on the date the property was first purchased and placed in service by the seller-lessee.

III. BASIS

A. In General

The basis of eligible property means the cost of property. Cost means the lesser of either:

- (1) The actual invoice price of eligible property; or
- (2) The basis from which a deduction is taken under Code section 167 (with respect to depreciation) or under Code section 168 (with respect to ACRS).

B. Partners, S Corporation Shareholders, And Beneficiaries Of Estates Or Trusts

1. In General

Each partner of a partnership, shareholder of a S corporation, or beneficiary of an estate or trust shall separately take into account for the partner's, shareholder's, or beneficiary's taxable year with or within which the partnership, S corporation, or the estate of trust's taxable year ends, the partner's, shareholder's, or beneficiary's share of the basis and resulting credit for eligible property. The basis of eligible property is determined at the partnership, S corporation, or estate or trust level. The credit is for eligible property which is purchased and placed in service by the partnership, S corporation, or estate or trust during its respective taxable year. Each partner, shareholder, or beneficiary shall be treated as the taxpayer with respect to the partner's, shareholder's, or beneficiary's share of the basis of partnership, S corporation, or estate or trust eligible property. Partnership, S corporation, or estate or trust eligible property, by reason of each partner's, shareholder's, or beneficiary's taking its respective share of the basis into account, shall not lose its character as eligible property.

2. Partnership

Each partner's share of the basis of eligible property shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership. This is the rule regardless of whether the partnership has a profit or loss for the taxable year during which the eligible property is purchased and placed in service; however, if the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio which is in effect on the date on which the property is purchased and placed in service shall be applied.

The basis of partnership eligible property which is subject to a special allocation that is recognized under Code section 704(a) and (b) shall be recognized for purposes of the credit.

3. S Corporation

Each shareholder's basis of eligible property is the shareholder's allocated share of the corporation's basis in the eligible property.

4. Estate Or Trust

In the case of an estate or trust, the basis of eligible property for any taxable year is apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each. If during the taxable year of an estate or trust, a beneficiary's interest in the income of the estate or trust terminates, the basis of the eligible property which is purchased and placed in service by the estate or trust after the termination is not to be apportioned to the beneficiary.

The term "beneficiary" includes an heir, legatee, or devisee.

5. Examples

Example 1. Partnership ABCD purchases and 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 purchased and 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 same facts as in example 1 above, 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 purchased and 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 purchased and placed in service on January 1 and 50 per cent of the basis of the eligible property which was purchased and 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 purchased and placed in service by the partnership in 1988.

C. Basis Limitation If A Deduction Is Taken Under Code Section 179

If a deduction is taken under Code section 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.

Example 1. A taxpayer purchases section 179 property (as defined in Code section 179(d)) for \$5,000. The taxpayer elects to treat \$2,000 of the cost of the property as an expense which is not chargeable to capital account. In this case, the taxpayer shall only be allowed to compute the credit on a basis of \$3,000 (\$5,000 less \$2,000).

D. Basis Limitation For Automobiles

For purposes of determining the amount of credit available, the basis for passenger automobiles used predominantly (over 50 per cent) for business purposes is limited to \$11,250. The \$11,250 basis limitation figure is derived from Code section 280F(a)(1) which is adopted by section 235-110.7(d), HRS (\$11,250 multiplied by six per cent applicable federal rate equals the \$675 investment tax credit limitation figure for passenger automobiles). The limit applies to 4-wheeled vehicles rated at 6,000 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.

Example 1. Taxpayer purchases and places in service a \$20,000 passenger automobile for business use in calendar year 1989. The maximum credit allowable in this case is \$450 (\$11,250 multiplied by four per cent).

This limitation applies prior to any percentage reduction for personal use (as discussed in section III(E) of this TIR). Thus, if the taxpayer in example 1 above uses the automobile for personal purposes 25 per cent of the time in the year the automobile is purchased and placed in service, the maximum credit is \$337.50 (\$450 multiplied by 75 per cent).

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.

E. Basis Limitation For Listed Property Which Does Not Satisfy The More-Than-50 Per Cent Business Use Test

Listed property will not be treated as eligible property, and the credit is denied if the property does not satisfy the more-than-50 per cent business use test. 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.

The more-than-50 per cent business use test requires that certain business use of property (referred to as qualified business use) exceeds 50 per cent.

If the business use exceeds the more-than-50 per cent business use test, but is not used 100 per cent for business, the amount of credit is limited to the percentage of business use.

Example 1. A listed property is used 60 per cent for business and otherwise qualifies for the credit. In this case, the taxpayer is allowed to determine the amount of credit available based on only 60 per cent of the basis.

For purposes of determining the more-than-50 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-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 available.

Example 2. A taxpayer uses listed property in a business in the taxable year in which it is purchased and placed in service. The business use percentage for the listed property is not greater than 50 per cent. In this case, since the taxpayer does not satisfy the more-than-50 per cent business use test, no credit is allowed for the listed property.

Example 3. A calendar year taxpayer purchases and places in service in 1989, listed property with a cost of \$5,000. The 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, the credit is determined and allowed on 90 per cent (55 per cent plus 35 per cent) of the basis which is the combined business use. The credit allowable is \$180 (90 per cent of \$5,000 multiplied by the four per cent applicable credit rate in 1989).

Example 4. The taxpayer purchases and places in service in 1989, listed property that is used 45 per cent for qualified business use and 55 per cent for investment purposes. In this case, no credit is

allowable because the taxpayer does not satisfy the more-than-50 per cent business use test.

The amount of credit allowable in the taxable year in which the property is purchased and 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 property may be subject to recapture.

IV. AMOUNT OF CREDIT

A. In General

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 tax 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 purchased and 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 the 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.

V. 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 purchased and placed in service by the taxpayer. Generally, property which is eligible for the credit is (A) section 38 property, (B) new section 38 property, and (C) used section 38 property.

A. Section 38 Property

Section 38 property is generally defined as:

- (1) Property which is (A) tangible personal property, or (B) other tangible property;

- (2) Recovery property (within the meaning of Code section 168, without regard to useful life), or any other property with respect to which depreciation (or amortization in lieu of 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 purchased and 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.

1. Tangible Personal Property

Tangible personal property may qualify as section 38 property:

- (1) If the property is not an air conditioning or heating unit;
- (2) Regardless of whether it is used as an integral part of manufacturing, production, extraction, or furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services;
- (3) Regardless of whether it is a research or storage facility used in connection with any of the activities referred to in paragraph (2) above; and
- (4) Regardless of whether it is used in connection with any of the activities referred to in paragraph (2) above for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).

2. Other Tangible Property

In addition to tangible personal property, other tangible property may qualify as section 38 property if one of the following conditions is met:

- (1) The property is used as an integral part of manufacturing, production, extraction, or furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services;
- (2) The property is a research or storage facility used in connection with any of the activities referred to in paragraph (1) above; or
- (3) The property is a facility used in connection with any of the activities referred to in paragraph (1) above for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state).

3. Definitions For Terms Used In Connection With Tangible Personal Property And Other Tangible Property

See the Treasury Regulations in connection with Code section 48, as amended as of December 31, 1984, for definitions of the following terms: (1) manufacturing, production and extraction; (2) transportation businesses; (3) communication businesses; (4) integral part of one of the specified activities; (5) research or storage facility; and (6) bulk storage.

4. Recovery Property/Depreciable Property

Section 38 property must be either recovery property (within the meaning of Code section 168, without regard to useful life), or any other property with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer.

If only part of a property is depreciable, only a pro rata portion of the property may qualify as section 38 property.

Example 1. 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.

Property does not qualify as section 38 property to the extent that a deduction for depreciation thereon is disallowed under Code section 274 (regarding the disallowance of certain entertainment, etc., expenses).

5. 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;
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. Exceptions to this general rule are stated in Code section 48(a)(4), as amended as of December 31, 1984;
4. Intangible property (e.g., patent, copyright, subscription list); and
5. Property used for lodging.

a. Building And Its Structural Components

In the case of both tangible personal property and other tangible property, a building and its structural components do not qualify as section 38 property.

(i) Building

Generally, 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.

A building does not include (a) a structure which is essentially an item of machinery or equipment, or (b) 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.

Factors which indicate that a structure is closely related to the use of a particular property it houses include the following: (1) the structure is specifically designed to provide for the stress and other demands of the property; and (2) 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.

(ii) Structural Component

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:

- (1) The manner of affixation (permanent or detachable) of the property to the land;
- (2) Whether the property is capable of being moved, and whether it has in fact been moved;
- (3) Whether the property is designed or constructed to remain permanently in place;
- (4) Circumstances which tend to show the expected or intended length of affixation;
- (5) Whether the removal of the property is substantial and time consuming;

(6) Whether the property is readily removable; and

(7) The extent of damage that the property will sustain if it is removed.

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.

The term structural component does not include 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.

b. Property Used For Lodging

The term "section 38 property" generally does not include property which is used predominantly (1) to furnish lodging, or (2) in connection with the furnishing of lodging (as defined in the Treasury Regulations regarding Code section 48(a)(3), as amended as of December 31, 1984).

There are three exceptions to this general rule. First, 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. Examples include restaurants, drug stores, grocery stores, and vending machines located in the lodging facility.

Second, property used by a hotel or motel 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, etc., is used by transients may qualify as section 38 property. An accommodation shall be considered to accommodate transients if the rental period is normally less than 30 days. Thus, if greater than one-half of the living quarters of a hotel, motel, etc., is used during the taxable year to accommodate transients, the property used by the hotel, motel, etc., may qualify as section 38 property which is eligible for the credit. On the other hand, if one-half or less of the living quarters of a hotel, motel, etc., is used during the taxable year to accommodate transients, the property used by the hotel, motel, etc., would not qualify as section 38 property.

Third, coin-operated vending machines and coin-operated washing machines and dryers may qualify as section 38 property.

B. New Section 38 Property

New section 38 property qualifies for the credit. New section 38 property is:

- (1) Section 38 property, the original use of which commences with the taxpayer; or
- (2) Section 38 property which is originally purchased and placed in service by a taxpayer, and is sold and leased back by that same taxpayer, or is leased to that same taxpayer, within three months after the date the property was originally purchased and placed in service.

The term "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. In a sale-leaseback situation, however, the original use begins not earlier than the date the property is used under the lease.

Example 1. A taxpayer (1) buys property from a manufacturer, (2) purchases and places it in service, and (3) sells and leases the property back within three months of the date that it was originally purchased and placed in service. In this case, the original use begins not earlier than the date the property is used under the lease.

C. Used Section 38 Property

Used section 38 property is:

- (1) Section 38 property;
- (2) Not new section 38 property, as defined in section V(B) of this TIR; and
- (3) Property which is not used by the same person (i.e., taxpayer or a related person as defined in Code section 179(d)(2)(A) or (B)) both before and after the purchase.

1. 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.

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.

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Example 1. 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.

Property sold under a sale-leaseback arrangement in the hands of the purchaser-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.

VI. RECAPTURE OF CREDIT: CERTAIN DISPOSITIONS, ETC., OF SECTION 38 PROPERTY

Subject to exceptions, a recapture rule applies to recompute previously taken credit if eligible property is disposed of or otherwise ceases to be eligible property. The recapture rule will be discussed in a separate TIR which is to be distributed at a later date.


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