

JOHN WAIHEE
GOVERNOR



RICHARD F. KAHLER, JR.
DIRECTOR TAXATION

GARY S. MIJO
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

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TAX INFORMATION RELEASE

No. 88-8

RE: Capital Goods Excise Tax Credit Recapture

This Tax Information Release ("TIR") is limited to the issue of the recapture of the capital goods excise tax credit ("credit"), except where otherwise stated. Refer to TIR No. 88-6 for discussion of other credit-related issues.

Although Code section 47, as amended as of December 31, 1984, which is adopted by section 235-110.7(d), HRS, sets forth different methods for investment tax credit ("ITC") recapture, the method of recapture for purposes of the credit does not track all ITC principles. The Department has used only those ITC principles of recapture that apply due to the fact that the availability of the credit is based on limited ITC grounds. Those ITC principles of recapture used in this TIR were also chosen for ease of administration for both the taxpayer and the Department.

I. GENERAL DEFINITIONS FOR PURPOSES OF TIR NO. 88-8

"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, unless otherwise stated.

"Eligible property" means section 38 property, new section 38 property, or used section 38 property (as defined in section V of TIR No. 88-6).

"Recapture period" means the period beginning on the first day of the month the eligible property is purchased or placed in service (as defined in section II of TIR No. 88-6), whichever is earlier, and extending for a full three years.

II. RECAPTURE OF CREDIT: CERTAIN DISPOSITIONS, ETC., OF ELIGIBLE PROPERTY

A. IN GENERAL

Subject to exceptions which are discussed in section III of this TIR, the 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. See section II(C) of this TIR for a discussion of when property ceases to be eligible property.

Pursuant to section 241-4.5, HRS, the credit as provided under section 235-110.7, HRS, TIR No. 88-6, and this TIR shall apply to banks and other financial corporations.

B. 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.

The following table determines the recapture percentage.

Recapture period: If the recovery property or depreciable property ceases to be eligible property within:

(i)	One full year after Purchased and 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-

Example 1. On June 15, 1989, Taxpayer A purchases and 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 for taxable year 1989 is \$400 ($\$10,000 \times 4\%$). On June 16, 1991, A sells the asset. In taxable year 1991, A must recapture \$132 ($\$400 \times 33\%$) of the previously taken credit.

An increase in income tax due to recapture is limited to the total credit claimed.

A recomputation of the credit shall be made on Part II of Form N-312 which is provided by the Department.

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.

C. RECAPTURE EVENT (I.E., PROPERTY CEASES TO BE ELIGIBLE PROPERTY)

1. 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.

2. Decrease In The Business Use Of Listed Property To Less Than 50 Per Cent

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 purchased and placed in service; or (2) the listed property is converted from business use to personal use and does not satisfy the more-than-50 per cent business use test. The terms "listed property" and "the more-than-50 per cent business use test" are defined in section III(E) of TIR No. 88-6.

Example 1. A, a calendar-year taxpayer, purchased and placed in service on January 15, 1988, an automobile for \$7,000. In 1988, A uses the automobile 75 per cent for business, 15 per cent 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 ($\$7,000 \times 90\% \times 3\%$). 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 $[(\$7,000 \times 90\% \times 3\%) - (\$7,000 \times 75\% \times 3\%)] \times 66\%$. 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 remained the same in taxable years 1989 and 1990, Code section 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 $[(\$7,000 \times 75\% \times 3\%) (\$7,000 \times 0\% \times 3\%)] \times 33\%$.

3. 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).

Example 1. A, a calendar-year taxpayer, purchased and placed 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 asset 80 per cent for business, and 20 per cent for personal purposes. Thus, for taxable year 1988, only 80 per cent, or \$16,000 ($\$20,000 \times 80\%$) of the basis of the asset qualifies as eligible property. The credit allowable in 1988 is \$480 ($\$16,000 \times 3\%$). 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 [$(\$20,000 \times 80\% \times 3\%) (\$20,000 \times 60\% \times 3\%) \times 66\%$].

4. Partnership, S Corporation, Estate, Or Trust

a. 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: (1) 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 (2) 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.

The term "specified percentage" 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 ("66 2/3 per cent rule"), and credit recapture will be required.

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 ("33 1/3 per cent rule"). Thereafter, any reduction in interest, however small, will again subject the partner, shareholder, or beneficiary to the recapture provisions.

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.

Example 1. General Facts. Corporation S, a calendar year S corporation, purchased and placed 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 had 200 shares of stock

outstanding which were owned equally by shareholders A and B, calendar year taxpayers. The total bases of the three eligible properties were apportioned to shareholders A and B as follows:

Total bases \$90,000

Shareholder A (100/200) . . . \$45,000
Shareholder B (100/200) . . . \$45,000

In taxable year 1988, each shareholder took a credit of \$450 ($\$15,000 \times 3\%$) for each of the three eligible properties, or a total credit of \$1,350 ($\$15,000 \times 3\% \times 3$).

Example 2. Assume the facts as in Example 1 above, 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 ($\$450 \times 66\%$) of their previously taken credit. Corporation X would not be subject to recapture because it never benefitted from the credit.

Example 3. Assume the facts as in Example 1 above, 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 ($\$1,350 \times 50\% \times 33\%$).

Example 4. Assume the facts as in Examples 1 and 3 above, 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 would not be subject to recapture.

Example 5. Assume the facts as in Example 1 above, 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 would not be subject to recapture.

b. S Corporation Election

Generally, if a 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 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 corporation prior to such last day) shall be considered as having ceased to be eligible property with respect to the corporation and the recapture rule shall apply. However, the recapture rule shall not apply if the 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 below.

The agreement shall: (1) be signed (a) by the shareholders, and (b) on behalf of the corporation by a person who is duly authorized; (2) 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 corporation during the recapture period and during a taxable year of the corporation for which the S election is effective, each signer agrees (a) to notify the director of a disposition or cessation, and (b) to be jointly and severally liable to pay the director an amount equal to the increase in tax provided by the recapture rule; (3) state the name, address, and taxpayer account number (e.g., social security number) of each party to the agreement; (4) be filed with the Department for the taxable year immediately preceding the first taxable year for which the S election is effective; and (5) 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.

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.

III. 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.

Example 1. A, a calendar-year taxpayer, purchases and places in service in 1988, eligible property with a basis of \$5,000. In taxable year 1988, A takes a credit in the amount of \$150 ($\$5,000 \times 3\%$). 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.

B. TRANSACTION TO WHICH CODE SECTION 381(a) APPLIES

A disposition of eligible property in a transaction to which Code section 381(a) (regarding 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.

C. 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: (1) the property is retained as eligible property in the same trade or business; (2) 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; (3) substantially all the property (whether or not eligible property) necessary to operate the trade or business is transferred in the change of form; and (4) 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).

This subparagraph shall not apply to the transfer of eligible property if Code section 381 (regarding carryovers in certain corporate acquisitions) applies to the transfer.

2. Substantial Interest

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: (1) substantial in relation to the total interest of all the owners; or (2) equal to or greater than the transferor's interest prior to the change in form.

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.

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.

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.

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.

3. S Corporation

Neither an election to be treated as an S corporation, nor a termination or loss of S corporate status automatically triggers recapture. However, recapture may result if either of the two recapture events discussed in section II(C)(4) of this TIR 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 II(C)(5) of this TIR) apply even if the corporation is no longer an S corporation.

4. 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: (1) eligible property is disposed of by the transferee (or otherwise ceases to be eligible property with respect to the transferee); or (2) 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 basis of the interests in the hands of the transferor).

A taxpayer who seeks to establish the taxpayer's interest in a trade or business under this exception (i.e., mere change in form of conducting a trade or business) must maintain adequate records to demonstrate the taxpayer's direct or indirect interest, or both, in the trade or business after any transfer.

D. SALE-LEASEBACK TRANSACTION

Recapture is not required when eligible property is disposed of and as part of the same transaction, is leased back to the seller within three months after the date the property was originally purchased and placed in service. This result occurs regardless of whether the seller-lessee recognizes a gain or loss, or that the seller-lessee is no longer entitled to take depreciation on the property. If, during the recapture period, the seller-lessee later terminates or assigns the lease, or otherwise disposes of the property, the seller-lessee may be subject to recapture. For recapture purposes, the recapture period will be measured from the earlier of the date the property was purchased or placed in service by the seller-lessee.

The law regarding recapture in a sale-leaseback transaction is directed to the seller-lessee because in a typical sale-leaseback transaction

involving the acquisition of eligible property by the buyer-lessor from the seller-lessee, the buyer-lessor is not eligible for the credit. The buyer-lessor is not eligible for the credit because the seller-lessee is treated as the owner of the property for credit purposes.

E. TRANSFER BETWEEN SPOUSES OR INCIDENT TO DIVORCE

A transfer between spouses or incident to divorce is not considered to be a disposition, subject to the recapture rule. However, a later 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.

This rule applies 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.

IV. 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 date the property is disposed of or otherwise ceases to be eligible property;
- (2) The estimated useful life or recovery period that was assigned to the property to determine eligibility for the credit;
- (3) The month and the taxable year in which the property was purchased or placed in service, whichever is earlier; and
- (4) The basis, actually or reasonably determined, of the property.

The above stated facts will be analyzed to determine both the eligibility for the credit, and the necessity for any recapture of credit.

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.

B. 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 and engineering practices, and consistent with the taxpayer's prior recordkeeping practices.

Mass assets means a mass or group of individual items of property (1) not necessarily homogeneous, (2) each of which is minor in value relative to the total value of the mass or group, (3) numerous in quantity, (4) usually accounted for only on a total dollar or quantity basis, and (5) with

respect to which separate identification is impracticable. Examples include portable air and electric tools, jigs, and hardware.

C. 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. The averaging convention provides for assumed dates that property is purchased and 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. The taxpayer must consistently use the assumed dates to compute the taxpayer's recapture credit on 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.

V. INCREASE IN INCOME TAX

An increase in income tax under this section shall be treated as income tax imposed on the taxpayer by chapter 235, HRS, for the recapture year. This is the rule despite the fact that absent the increase, the taxpayer has no income tax liability, has a net operating loss, or no income tax return is otherwise required for the taxable year.


RICHARD F. KAHLE, JR.
Director of Taxation