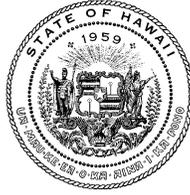


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TAX INFORMATION RELEASE NO. 2001-1

RE: The Application of Certain Hawaii Taxes to Qualified Subchapter S Subsidiary Corporations, Qualified Subchapter S Trusts, and Electing Small Business Trusts

This Tax Information Release (TIR) discusses: (1) Hawaii's conformity to the Internal Revenue Code (IRC) provisions relating to a qualified subchapter S subsidiary (QSub) and Hawaii income and withholding tax return filing requirements for a QSub; (2) Hawaii's conformity to the IRC provisions relating to a qualified subchapter S trust (QSST) and an electing small business trust (ESBT) and Hawaii income tax return filing requirements for a QSST and ESBT; (3) general excise/use tax licensing and return filing requirements for a QSub, QSST, and ESBT; (4) tax clearance procedures for a parent S corporation and a QSub; and (5) the application of the conveyance tax to real property transfers between a parent S corporation and a QSub, QSST and ESBT.

I. Hawaii Conformity and Income Tax Return Filing Requirements for a QSub

A. Hawaii Conformity

Act 297, Session Laws of Hawaii (SLH) 1997, (Act 297) conformed the Hawaii Income Tax Law (chapter 235, Hawaii Revised Statutes (HRS)) to IRC section 1361. Under IRC section 1361(b)(3), a parent S corporation may elect to treat a wholly-owned corporation as a QSub.

A QSub is a corporation that: (1) is 100 per cent owned by a parent S corporation; (2) is eligible to make a S corporation election; (3) the parent S corporation elects to treat as a QSub; and (4) is not an ineligible corporation as defined in IRC section 1361(b)(2). For income tax purposes, a QSub is treated like a division of the parent S corporation and is not recognized as a separate entity. The assets, liabilities, income, deductions, and credits of a QSub are treated as those of the parent S corporation.

If a QSub election is made for an existing corporation, the corporation is deemed to have liquidated into the parent S corporation in a tax-free liquidation under IRC sections 332 and 337 immediately before the election is effective.

The QSub election on federal Form 966 is recognized as a Hawaii QSub election pursuant to section 235-122(a), HRS. The parent S corporation must attach a copy of the federal Form 966 to the first Hawaii S corporation tax return filed following the federal QSub election.

B. Hawaii Income Tax Return Filing Requirements for a QSub

The parent S corporation must file a single Hawaii income tax return (Form N-35) using the parent's federal employer's tax identification number (FEIN) and general excise/use tax license number. The parent's return should include the assets, liabilities, income, deductions, and credits of the QSub.

C. Hawaii Withholding Tax Requirements for a QSub

A parent S corporation which reports the federal employment taxes of both the parent and the QSub under the parent's FEIN may use the parent's Hawaii employer withholding tax identification number to report Hawaii withholding taxes for the parent and QSub.

If the parent S corporation and QSub report federal employment taxes under separate FEINs, then the parent and the QSub must obtain separate Hawaii employer withholding tax identification numbers and file separate withholding tax returns.

II. Hawaii Conformity and Income Tax Return Filing Requirements for a QSST and an ESBT

Act 297 adopted the amendments to IRC section 1361 that allow certain trusts, including QSSTs and ESBTs, to own stock in a S corporation.

A QSST is a trust that meets the requirements of IRC section 1361 (d)(3) and the terms of which require that: (1) during the life of the current income beneficiary, there only is one beneficiary of the trust; (2) any corpus distributed during the life of the current income beneficiary may be distributed only to the beneficiary; (3) the income interest of the current income beneficiary terminates on the earlier of the beneficiary's death or termination of the trust; (4) upon termination of the trust during the life of the current income beneficiary, the trust must distribute all of its assets to the beneficiary; and (5) all of the income distributed (or required to be distributed) is distributed to the beneficiary who is a citizen or resident of the United States. The beneficiary is required to make a separate QSST election for the stock of each S corporation owned by the QSST. A federal QSST election is recognized as a Hawaii QSST election. A copy of the QSST election statement must be attached to the Hawaii fiduciary tax return for the first taxable year for which the QSST election is in effect.

A QSST must file a fiduciary tax return (Form N-40) to report the income taxable to its beneficiary. Hawaii conforms to IRC Regulation 1.671-4(b), which does not permit a QSST to use the simplified reporting procedures and forego the filing of a fiduciary tax return.

The sole beneficiary of the QSST is treated as the S corporation shareholder for the S corporation qualification requirements, as well as for the pass-through of income, losses, credits, distributions, and adjustments to the basis of the stock. Therefore, the beneficiary must file an individual Hawaii income tax return to report the income, losses, and credits distributed by the QSST to the beneficiary. *See* section 235-92(3), HRS (1993).

An ESBT is a trust that meets the requirements of IRC section 1361(e) that: (1) does not have any beneficiaries other than individuals, estates, or charitable organizations described in IRC section 170(c)(2) to 170(c)(5), relating to charitable organizations, war veterans organizations, fraternal lodges, and cemetery organizations which are eligible to be a S corporation shareholder; (2) the interests were not acquired by purchase, i.e., a transaction in which there is a cost basis; (3) has made an election with the IRS to be treated as an ESBT; (4) has not made an election to be treated as a QSST with respect to any S corporation stock held by the trust; and (5) is not a tax-exempt trust or a charitable remainder annuity trust or unitrust. A federal ESBT election is recognized as a Hawaii ESBT election. A copy of the federal ESBT election statement must be attached to the Hawaii fiduciary tax return for the first taxable year the ESBT election is in effect.

An ESBT must file a Hawaii fiduciary tax return to pay the income tax on the income attributable to the S corporation stock held by the ESBT. The taxable income of the ESBT includes the income, loss or deduction, and credits attributable to the S corporation stock, gain or loss from the sale of S corporation stock, and any Hawaii income taxes and administrative expenses properly allocable to the S corporation stock. The income is taxed at the highest Hawaii income tax rate for estates and trusts, but the capital gains tax rate under section 235-51(f), HRS, is allowed for net capital gains.

The ESBT's income distributable to a beneficiary does not include the income attributable to the S corporation stock. A beneficiary must file a Hawaii income tax return to report the income, losses and credits distributed by the ESBT to the beneficiary. *See* section 235-92(3), HRS (1993).

III. General Excise/Use Tax Licensing and Return Filing Requirements

A. S Corporation with a QSub

A parent S corporation which uses the parent's FEIN to report federal taxes for all entities, including a QSub, may not file returns on behalf of all entities under the parent's general excise/use tax license number. Section 237-9, HRS, requires any person subject to the GET, including a corporation, to have a general excise/use tax license number. A parent S corporation and QSub, therefore, must have separate general excise/use tax license numbers and separately file general excise tax returns. The parent S corporation and QSub are separate entities for purposes of the GET regardless of the filing of a single income tax return (because the QSub is treated as a division of the parent S corporation) or the reporting of federal employment taxes of both entities under the parent S corporation's FEIN.

A person or company having shareholders or members (a corporation, association, group, trust, partnership, joint adventure, or other person) is taxable upon its business with them, and they are taxable upon their business with it. *See* section 237-20, HRS (1993). *See* also In the Matter of the Tax Appeal of Wasson-Bendon Partners, 93 Haw. 267, (App. 2000) and In the Matter of the Tax Appeal of Island Holidays, Ltd., 59 Haw. 307 (1978) Intercompany transactions between the parent S corporation and the QSub are subject to the general excise tax (GET) unless specifically exempted, for example, under section 237-23.5, HRS.

Example 1: S Corp., elects QSub treatment for its wholly-owned subsidiary corporation. The QSub sells inventory to S Corp. for resale. The sale of inventory from the QSub to S Corp. is subject to the GET at the one-half percent rate and is reported under the general excise/use tax license number of the QSub.

Example 2: Assume the same facts as Example 1, except that S Corp. sells inventory to the QSub for resale. The sale of inventory from S Corp. to the QSub is subject to the GET at the one-half percent rate and is reported under the general excise/use tax license number of the S Corp.

Example 3: Assume the same facts as Example 1. S Corp. performs accounting services for the QSub. S Corp. charges the QSub for the accounting services. The amount charged by S Corp., otherwise taxable, is exempt from the GET under section 237-23.5, HRS, which exempts certain transactions between related entities.

B. QSST

A QSST and its sole beneficiary must have separate general excise/use tax licenses. Section 237-9.5, HRS, which exempts a trust from the licensing, registration, or filing requirements of the general excise tax law when the trust does not have a separate federal and Hawaii income tax filing requirement from its grantor or grantors, is not applicable because the QSST is required to file a Hawaii fiduciary tax return.

C. ESBT

An ESBT and its beneficiaries must have separate general excise/use tax licenses. Section 237-9.5, HRS, which exempts a trust from the licensing, registration, or filing requirements of the GET law when the trust does not have a separate federal and Hawaii income tax filing requirement from its grantor or grantors, is not applicable because the ESBT is required to file a Hawaii fiduciary tax return.

IV. Tax Clearance Procedures for a Parent S Corporation and a QSub

The department will not accept a tax clearance application (Form A-6) from a QSub for a liquor license renewal if the QSub uses the general excise/use tax number issued to the parent S corporation. The QSub must have its own separate general excise/use tax number.

Example 4: S Corp. makes a qualified QSub election with respect to its wholly-owned subsidiary corporations, X, Inc. and Y, Inc. S Corp., X, Inc. and Y, Inc. use one FEIN for federal tax reporting purposes. X, Inc. holds liquor licenses issued by each of the four county liquor commissions. The annual renewal of these licenses requires a Hawaii tax clearance certificate. The department will accept a Form A-6 from X, Inc. using S Corp.'s FEIN and the general excise/use tax license number of X, Inc.

Example 5. Assume the same facts as Example 4, except that S Corp., X, Inc., and Y, Inc. are licensed under three different general excise/use tax license numbers; X, Inc. holds a liquor license issued by Maui County and Y, Inc. holds a liquor license issued by the City and County of Honolulu, Y, Inc. has an

installment agreement with the department for the payment of delinquent GET, and is current on that agreement. The department will accept a Form A-6 from X, Inc. using the FEIN number of S Corp. and general excise/use tax license number of X, Inc., and issue a tax clearance certificate to X, Inc. if the income tax returns for S Corp. and its subsidiaries, and the GET and withholding returns for X, Inc. are all currently filed and the tax liabilities shown on the returns are fully paid. The department, however, will not issue a tax clearance certificate to Y, Inc. because the installment agreement does not satisfy Y, Inc.'s delinquent tax liability. A tax clearance certificate will not be issued if the applicant owes the State any delinquent taxes, penalties or interest and a liquor license will not be renewed without a tax clearance certificate See sections 231-28, 281-45, HRS, and Attorney General Opinion No. 95-1 (January 12, 1995).

V. Application of the Conveyance Tax

Chapter 247, HRS, imposes a conveyance tax on all transfers or conveyances of realty or any interest in realty by way of deeds, leases, subleases, assignments of lease, agreements of sale, assignments of agreements of sale, instruments, writings, and any other document.

A transfer of realty between a parent S corporation and a QSub is subject to the conveyance tax notwithstanding that the QSub is disregarded as a separate entity for Hawaii income tax purposes. Corporations, including S corporations, are separate legal entities for purposes of the conveyance tax.

A transfer of realty between a S corporation and a QSST or ESBT also is subject to the conveyance tax.

Forms and other tax information may be downloaded from the Department's website at: www.state.hi.us/tax. On Oahu, forms may be ordered by calling the Department's Forms Request Line at: 808-587-7572. Persons who are not calling from Oahu may call: 1-800-222-7572 to receive forms by mail or 808-678-0522 from a fax machine to receive forms by fax.

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HRS Sections Explained: HRS 235-2.3, 235-62, 235-92, 235-95, 235-122, 237-1, 237-9, 237-9.5, 247-1.