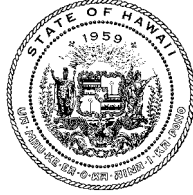


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July 23, 1999

TAX INFORMATION RELEASE NO. 99-2

RE: Dividends Received Deduction

On February 26, 1998, the Department of Taxation (Department) issued Announcement No. 98-5 which stated that the Department was administering the 70% dividends received deduction provided by section 235-7(c), Hawaii Revised Statutes (HRS) (1993), without regard to the threshold requirement of Hawaii activity, ownership, or presence. The Department also recognized that other provisions in section 235-7(c), HRS, relating to the 100% dividends received deduction for qualifying dividends received by members of an affiliated group and 100% dividends received deduction for dividends received by a small business investment company would be deemed unconstitutional.

In this Tax Information Release (TIR), we announce that the 100% dividends received deduction is being administered without regard to the discriminatory requirements. A corporation may therefore claim a 100% deduction under section 235-7(c), HRS, for: (1) qualifying dividends as defined in section 243(b), IRC, received by members of an "affiliated group," as defined, but without regard to the limitation to domestic corporations; and (2) dividends received by a small business investment company operating under the Small Business Investment Act of 1958 upon shares of stock of another corporation without regard to the Hawaii threshold requirement.

Under current law, section 235-7(c), HRS, provides a 100% deduction for: (1) dividends received by any corporation from the shares of stock of a national banking association; (2) qualifying dividends, as defined in section 243(b) of the Internal Revenue Code (IRC), received by members of an affiliated group; or (3) dividends received by a small business investment company operating under the Small Business Investment Act of 1958 upon shares of stock of another corporation, if at least 15% of the latter corporation's business (for the taxable year of the latter corporation preceding the payment of the dividends) has been attributed to Hawaii.

The 100% deduction for dividends received by members of an "affiliated group" would be deemed unconstitutional because "qualifying dividends" do not include dividends received from foreign (non-United States) corporations. This is in violation of the Foreign Commerce Clause of the United States Constitution under Kraft General Foods, Inc. v. Iowa Dep't of Revenue and Fin., 505 U.S. 71 (1992). In Kraft, the United States Supreme Court held that Iowa's corporate income tax unconstitutionally discriminated against foreign commerce because it allowed a

deduction for dividends received from domestic subsidiaries (United States), but not for those received from foreign (non-United States) subsidiaries. Kraft, 505 U.S. at 74. Under section 235-7(c), HRS, a corporation may claim a 100% deduction for “qualifying dividends,” as defined in section 243(b) of the Internal Revenue Code (IRC), received by members of an “affiliated group.” Under section 243(b), IRC, the definition of “affiliated group” (which incorporates the definition in IRC section 1504(a)(1)) does not include foreign (non-United States) corporations. Therefore, like the Iowa corporate income tax, section 235-7(c), HRS, unconstitutionally discriminates against foreign (non-United States) corporations.¹

Section 235-7(c), HRS, allows a small business investment company to claim a 100% deduction for dividends received from another corporation if at least 15% of the corporation’s business for the taxable year preceding the payment of the dividends has been attributed to Hawaii. This would be deemed unconstitutional because it discriminates against corporations doing business outside of Hawaii in violation of the Commerce Clause of the United States Constitution in the same manner as the intangible property tax in Fulton Corp. v. Faulkner, 516 U.S. 325 (1996). In Fulton, North Carolina imposed an intangible property tax on the value of stock owned by resident taxpayers, but allowed taxpayers a deduction based on a percentage of the corporation’s income subject to North Carolina income tax. Under this taxing scheme, the stock in a corporation operated solely within North Carolina would not be subject to tax. Such a corporation would report 100% of its income, and the percentage deduction allowed to resident taxpayers who owned stock in a corporation operated solely within North Carolina would be 100%. On the other hand, stock in a corporation doing no business in North Carolina would be taxable on 100% of its value. The United States Supreme Court held that North Carolina’s intangible tax scheme discriminated against interstate commerce. The taxing scheme made it easier for corporations operated solely within North Carolina to raise capital and discouraged North Carolina corporations from engaging in business outside of North Carolina. Similarly, by requiring a 15% threshold of Hawaii economic activity, section 235-7(c), HRS, discriminates against corporations doing business outside of Hawaii in violation of the Commerce Clause of the United States Constitution.

The Department announces that it is has been administering section 235-7(c), HRS, without regard to these discriminatory requirements in a manner consistent with the foregoing United States Supreme Court opinions. Therefore, a corporation may claim a 100% deduction for: (1) qualifying dividends as defined in section 243(b), IRC, received by members of an “affiliated group,” as defined in sections 243(b)(2) and 1504(a), IRC, except that “includible corporation” as used therein shall include foreign (non-United States) corporations; and (2)

¹ The definitions of a “domestic corporation” and a “foreign corporation” in section 7701, IRC, are used under section 235-7(c), HRS. Section 7701, IRC, defines a “domestic corporation” as a “...corporation...created or organized in the United States or under the law of the United States or of any State.” A “foreign corporation” is defined as “a corporation...which is not domestic.”

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dividends received by a small business investment company operating under the Small Business Investment Act of 1958 upon shares of stock of another corporation without considering the Hawaii threshold requirement.

The deduction may be claimed on schedule C of the 1998 Form N-30 and the appropriate schedule for prior years.

Forms and other tax information may be downloaded from the Department's website at <http://www.state.hi.us./tax/tax.html>. On Oahu, forms may be ordered by calling the Department's Forms Request Line at: 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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