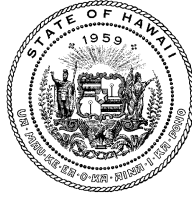


BENJAMIN J. CAYETANO
GOVERNOR

MAZIE HIRONO
LT. GOVERNOR



RAY K. KAMIKAWA
DIRECTOR OF TAXATION

MARIE Y. OKAMURA
DEPUTY DIRECTOR

Tel: (808) 587-1540
Fax: (808) 587-1560

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

December 8, 1999

TAX INFORMATION RELEASE NO. 99-4

Re: Application of the Franchise Tax, General Excise Tax, and Income Tax to Mortgage Loan Companies, Including Mortgage Loan Companies Organized as Passthrough Entities and Sole Proprietorships

This Tax Information Release (TIR) provides guidance on the taxation of mortgage loan companies, including mortgage loan companies organized as passthrough entities and sole proprietorships, under Hawaii's tax laws.

The Hawaii franchise tax is applicable to a "mortgage loan company." A mortgage loan company is a company licensed under the Mortgage Brokers and Solicitors Law, chapter 454, Hawaii Revised Statutes (HRS). Haw. Rev. Stat. §§241-1, 241-1.5 (1993).

Both "mortgage brokers" and "mortgage solicitors" are licensed under chapter 454, HRS. A mortgage broker will be subject to the franchise tax as a mortgage loan company when the company does business as a sole proprietorship, partnership, corporation, association, or other organization. A mortgage solicitor however, is an individual who performs the same functions as a mortgage broker but must be employed by a mortgage broker. See Haw. Rev. Stat. §§454-1, 454-2, 454-3(g)-(h) (1993). Accordingly, a mortgage solicitor is an employee (instead of an independent contractor) and will be subject to the Hawaii income tax on salary or wages received from the mortgage broker. Haw. Rev. Stat. §§241-3 (1993), 235-51 (1998 Supp.). This TIR discusses the taxation of mortgage brokers as mortgage loan companies (subject to the franchise tax), and not mortgage solicitors (subject to the income tax).

I. General Rule

The franchise tax is levied annually at the flat rate of 7.92 percent of the entire net income of mortgage loan companies and other finance businesses. Haw. Rev. Stat. §§241-2, 241-3 (1993), 241-4 (1998 Supp.). The franchise tax is applicable to the entire net income of mortgage loan companies including: (A) interest, discount, points, commitment fees, loan fees, loan origination charges, certain finance charges; (B) leasing of personal property; (C) fees or charges relating to the administration of deposits; (D) certain foreign currency gains; (E) servicing and sale of certain loans; and (F) interest received from certain investments of deposits. These amounts along with the applicable expenses are reported on the franchise tax return (Form F-1).

II. General Excise Tax Exemption for Mortgage Loan Companies

The general excise tax is not applicable to the above amounts received by mortgage loan companies subject to the franchise tax. Haw. Rev. Stat. §237-24.8 (1993). However, gross income not specifically exempt under section 237-24.8, HRS, will be subject to the general excise tax. Haw. Rev. Stat. §237-13 (1998 Supp.).

III. Hawaii Income Tax Exemption for Mortgage Loan Companies

The income tax is not applicable to mortgage loan companies because the Hawaii franchise tax is imposed in lieu of the income tax. Haw. Rev. Stat. §235-9 (1993). (The amounts received by a mortgage loan company described above as exempt from the general excise tax are also exempt from the income tax.)

IV. Application of the Franchise Tax to Mortgage Loan Companies Doing Business as “Passthrough Entities,” to the Partners, Shareholders, Members, and Beneficiaries of the “Passthrough Entities,” and Sole Proprietorships

A. Background

This part IV of this TIR explains the Department’s position regarding the application of the franchise tax to mortgage loan companies which do business as “passthrough entities” and sole proprietorships.

- ! A “passthrough entity” (e.g., partnership, including a business entity classified as a partnership for tax purposes) is subject to the franchise tax rather than the income tax. Its owners (e.g., partners, shareholders, members, or beneficiaries), are subject to the income tax on the distributive share of income from the mortgage loan company.

- ! An individual operating a mortgage loan company in the form of a sole proprietorship is subject to the franchise tax on income from the mortgage loan company business, as well as the income tax on income which is not from the mortgage loan company business.

B. Passthrough Entities and Their Owners

The franchise tax is levied on the entire net income of the mortgage loan company from all sources for the preceding calendar year, where the entire net income is determined in the same manner as the taxable income of a corporation under the Income Tax Law, chapter 235, HRS, subject to certain adjustments. Haw. Rev. Stat. §241-4 (1998 Supp.).

The Income Tax Law allows certain passthrough entities (e.g., partnerships, including business entities classified as partnerships such as limited liability companies, S corporations, or trusts) to avoid being taxed directly upon their income. The partners, shareholders, members, or beneficiaries of those entities are instead taxed on their distributive shares of the entities' income. This is commonly known as "passthrough treatment."

Passthrough treatment is not appropriate under the Franchise Tax Law for the following reasons:

First, when the Franchise Tax Law was enacted in 1957, the predecessor of section 241-4, HRS, provided that the entire net income of a finance business, including a mortgage loan company, be determined the same as a corporation. Neither part VII of the Income Tax Law (with respect to the Hawaii S Corporation Income Tax Act) nor the provisions in subchapter S of the Internal Revenue Code of 1986, as amended, (IRC) allowing certain corporations to elect passthrough treatment, however, had been adopted. Thus, the original language of the Franchise Tax Law contemplated the net income of a mortgage loan company be determined the same as a C corporation. That language is still in section 241-4, HRS, as it exists today.

Second, the passthrough provisions of the Income Tax Law require that the partners, shareholders, or beneficiaries, respectively, be subject to income taxation. Since partners, shareholders, members, and beneficiaries generally are not subject to the franchise tax, the Income Tax Law's passthrough provisions are not applicable under the Franchise Tax Law.

Third, section 241-2(b), HRS, states that nothing in chapter 241, HRS, shall be construed to preclude the inclusion of dividends or distributions from national banking associations in the income of individuals under the Income Tax Law the same as dividends from domestic corporations are included in income. This provision supports an inference that equity distributions from a mortgage loan company and other financial institutions are included in the distributee's income as dividends when distributed.

Fourth, tax at the entity level is consistent with the fact that the franchise tax is in lieu of the general excise tax (as to mortgage loan company receipts as such) which is imposed at the entity level.

Accordingly, any mortgage loan company which is a passthrough entity shall report its entire net income under the Franchise Tax Law rather than the Income Tax Law. The income tax consequences to a partner, shareholder, member, or beneficiary, upon federal Schedule K-1 distributive share of income from a mortgage loan company shall be governed under the Income Tax Law.¹

¹ Amounts received by members for services provided to a mortgage loan company which is a passthrough entity will continue to be subject to the income tax. For example, partners receiving guaranteed payments will be

A mortgage loan company which is a passthrough entity should not file partnership, S corporation, or fiduciary returns (Forms N-20, N-35, or N-40, respectively) with the Department of Taxation.

C. Sole Proprietors

The Franchise Tax Law was amended in 1992, by Act 106, Session Laws of Hawaii, 1992, to allow the imposition of the franchise tax upon individuals engaged in the mortgage loan company business, raising a number of questions relating to the taxation of these individuals.

1. Will individuals be subject to both the income and franchise taxes?

Individuals engaged in a mortgage loan company business (i.e., mortgage broker) will be subject to the franchise tax on income from the mortgage loan company business and to the income tax on income other than income from the mortgage loan company business. The franchise tax is not applicable to income other than income from the mortgage loan company business, such as interest income from personal savings accounts, portfolio gains, or dividends. Any such items not subject to the franchise tax are subject to the income tax under chapter 235, HRS. Section 241-1.5(h), HRS, provides that if a taxpayer terminates business operations in a year, the franchise tax is payable only for that part of the year in which the taxpayer conducted a mortgage loan company business.

The entire net income subject to the franchise tax is determined in the same manner as the taxable income of a corporation under the Income Tax Law. Haw. Rev. Stat. § 241-4(b) (1998 Supp.). This provision specifies that exemptions and deductions specific to individuals, such as the deduction for personal exemptions or the deduction for mortgage interest paid are not allowed under the Franchise Tax Law. Also, the deduction allowed individuals for half of the federal self-employment taxes paid under IRC section 164(f) as well as certain health insurance costs of self-employed individuals under IRC section 162(l) will not be allowed against the franchise tax. (These deductions, however, are allowed on the federal Schedule C, with respect to any such business.)

2. How will individuals engaged in a mortgage loan company business report their income taxes and franchise taxes?

a. Income Tax

subject to the income tax. S corporation shareholders who receive wages or dividends will be subject to the income tax on that income.

As explained below, the income and expenses of an individual operating a mortgage loan company in the form of a sole proprietorship will be reported on the Form F-1, as discussed in this TIR. All other income and expenses which are not from the mortgage loan company business, if any, must be reported on the income tax return on federal Schedule C and then reported on the applicable Hawaii income tax return. (Hawaii does not require the filing of a separate Schedule C.)

b. Franchise Tax

The income and expense amounts and expenses of a mortgage loan company must be reported on Form F-1. Expenses and deductions unique to individuals (e.g., personal exemptions, deduction for half of the federal self-employment taxes, health insurance costs of self-employed individuals), however, will not be allowed. Other expenses attributable to the mortgage loan company typically reported under federal Schedule C, such as advertising, car expenses, depreciation, legal and professional services, office expenses, rent or lease expenses, repairs and maintenance, travel, and utilities, shall be reported on Form F-1.

In general, the franchise tax is imposed on the first day of the mortgage loan company's calendar or fiscal year. The franchise tax, however, is based upon the mortgage loan company's taxable income year for the preceding taxable year and is reported and paid on Form F-1. The mortgage loan company however, may elect to pay the franchise tax in quarterly installments unless the total franchise tax liability exceeds \$100,000, in which case the franchise tax must instead be paid in equal monthly installments. Haw. Rev. Stat. §§ 241-1.5, 241-1, 241-4, 241-5 (1993).

3. Credits

Individual taxpayers engaged in a mortgage loan company business are eligible for credits under the Income Tax Law. If the Franchise Tax Law also allows the credits, such as the capital goods excise tax credit, energy conservation credit, and low-income housing credit, those credits shall only be taken on the Form F-1 if they relate to the mortgage loan company business. The credits shall not be allowed under both the Income Tax Law and the Franchise Tax Law for the same property.

For example, if the taxpayer is eligible for the refundable capital goods excise tax credit or the nonrefundable energy conservation credit on property placed in service in the mortgage loan company business, the credit shall be taken on Form F-1 under section 241-4.5 or 241-4.6, HRS, respectively. Otherwise, the credit shall be taken against the taxpayer's net income tax liability under section 235-12 (with respect to the

energy conservation credit) or 235-110.7 (with respect to the capital goods excise tax credit), HRS. The credit shall not be allowed under both the Income Tax Law and the Franchise Tax Law for the same property.

Section 235-55, HRS, provides an income tax credit for resident individual taxpayers subject to an income tax levied by another state or country. Although the income of a mortgage loan company may be subject to income taxation by another state or country, the same income is not subject to Hawaii income tax because it is subject to the franchise tax. Accordingly, the income tax credit under section 235-55, HRS, will not be allowed with respect to income of a mortgage loan company.

V. Effective Date of Reporting Requirements

These reporting requirements will be effective immediately for all taxable years beginning after the date of this TIR. If mortgage loan companies have filed incorrectly under the general excise tax and income tax instead of the franchise tax, amended returns need not be filed if franchise tax returns are filed henceforth.

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.

Marie Y. Okamura
for RAY K. KAMIKAWA
Director of Taxation

HRS Sections Explained: §§ 235-9, 235-12, 235-51, 235-55, 235-110.7, 235-111, 235-111(b), 237-24.8, 237-40, 237-40(d), 241-1, 241-1.5(h), 241-2, 241-2(b), 241-3, 241-4, 241-4(b), 241-4.5, 241-4.6, 241-5, 454-1, 454-2, 454-3(g)-(h)