

DEPARTMENT OF TAXATION

Amendments to Chapter 18-237
Hawaii Administrative Rules

August 17, 1998

SUMMARY

1. A new §237-16.5-01 is added.
2. A new §237-16.5-02 is added.
3. A new §237-16.5-03 is added.
4. A new §237-16.5-04 is added.
5. A new §237-16.5-05 is added.
6. A new §237-16.5-06 is added.
7. A new §237-16.5-07 is added.

§18-237-16.5-01 Definitions. For purposes of sections 18-237-16.5-02 to 18-237-16.5-07, unless the context otherwise requires:

"Lease" means the rental of real property under an instrument in writing by which one conveys real property for a specified term and for a specified consideration, and includes the written extension or renegotiation of a lease, and any holdover tenancy.

"Lessee" means one who holds real property under a lease, and includes a sublessee. A lessee or sublessee includes a sublessor subject to both the tax and applicable deduction under section 237-16.5, HRS, provided real property or space is conveyed by a sublease.

"Lessor" means one who conveys real property by a lease, and includes a sublessor. A lessor does not include a person who is not subject to the taxes imposed by chapter 237, HRS, or a person whose gross proceeds or gross income from leasing the real property or space is not taxable under chapter 237, HRS.

Example 1: L leases unimproved Hawaii real property X to A. A then subleases real property X and A's improvements (e.g., Building Y) to B. Finally, B subleases real property X and Building Y to C. Assume that L, A and B are taxable under chapter 237, HRS, on their respective rental income from real property X and Building Y. L, A, and B are lessors. A, B, and C are lessees.

"Personal services" means services that are unrelated to the "operation of the property" (as the term is defined in section 514A-3, HRS) such as secretarial services, messenger services, and receptionist services because the services directly benefit the lessee's real property or space rather than the common elements of the real property or space.

"Real property or space" means the area actually rented and used by the Lessee, including common elements as defined in section 514A-3, HRS. Real

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property or space does not include the use of tangible personal property or the bundling of "personal services," or both; such items instead being subject to tax on other business as provided in section 237-13(10), HRS. If a sublease does not specifically include the use of tangible personal property or the receipt of personal services, it is presumed that the sublessor is subject to the tax and is allowed the sublease deduction under section 237-16.5, HRS. If it is determined that the real property or space includes tangible personal property or the bundling of personal services or both, the real property or space shall instead be subject to tax on other business under section 237-13(10), HRS, unless the sublessor complies with section 18-237-16.5-07 by providing proof satisfactory to the department of taxation of the portion subject to the tax and sublease deduction under section 237-16.5, HRS.

Example 2: Assume the same facts as Example 1 above except that sublessor B subleases real property X and Building Y to C and the written sublease to C does not specifically include the use of tangible personal property by C or the receipt of personal services by C. B is presumed to be subject to tax under section 237-16.5, HRS, and qualifies for the sublease deduction. If the department of taxation; however, later determines that the "sublease" includes the use of tangible personal property or receipt of personal services or both, all of B's income will be subject to tax on other business under section 237-13(10), HRS, unless B complies with section 18-237-16.5-07 by providing proof satisfactory to the department of taxation of the portion which is subject to tax under section 237-16.5, HRS, and qualifies for the sublease deduction. The remaining portion of the gross income attributable to tangible personal property, personal services, or both shall be subject to tax on other business under 237-13(10), HRS.

"Sublease" includes the rental of real property which is held under a lease and is made in a written document by which one conveys real property for a specified term and for a specified consideration. A sublease includes the written extension or renegotiation of a sublease, any holdover tenancy under the written sublease, multiple subleases of portions of the real property, and any number of successive subleases of the same real property or portions thereof.

"Sublessee" means one who holds real property under a sublease.

"Sublessor" means one who conveys real property by sublease under a lease. A sublessor includes a lessee subject to both the tax and applicable deduction as determined under section 237-16.5, HRS, provided a

sublease is conveyed. [Eff **OCT 01, 1998**] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-16.5)

§18-237-16.5-02 Tax on written real property leases; deduction allowed. (a) Section 237-16.5, HRS, imposes the general excise tax at the rate of four per cent upon the gross proceeds or gross income received or derived from the business of leasing real property in the State. A Lessee who subleases real property under a sublease shall be allowed a deduction from the amount of gross proceeds or gross income received from the Sublessee under section 237-16.5, HRS, and sections 18-237-16.5-03 to 18-237-16.5-06. In no case shall the amount of the deduction exceed the total amount received from the sublease of the real property.

Example 3: Lessor L leases its building to lessee A, who does not sublease the building or any portion of the building. A is subject to the tax under section 237-16.5, HRS, but is not allowed the sublease deduction because there is no sublease.

(b) The requirements for the sublease deduction are as follows:

- (1) The Lessor must submit to the Lessee, a certificate that certifies that the Lessor is licensed and taxable under the general excise tax law;
- (2) The Lessee must be licensed and taxable under the general excise tax law;
- (3) The Lessee must report the amount paid to the Lessor, the amount of the sublease deduction, and the name and general excise tax number of the Lessor on the Lessee's general excise tax return in lieu of filing a copy of the certificate with the general excise tax return;
- (4) The Lessee's sublease deduction is limited to leases and subleases in writing and related to the same real property or space; and
- (5) The Lessee must compute the allocations required by section 18-237-16.5-04 and

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section 18-237-16.5-05 with no allowances for changes during the specified term of the sublease, provided that this requirement shall not apply to a lease with terms that vary in the amount of periodic rent due, including a percentage lease with fixed minimum rent, a percentage lease with no minimum rent, a combination percentage lease with fixed minimum rent or percentage leases with no minimum rent, whichever amount is higher, or a graduated or step-up lease.

(c) The form of the certificate shall be prescribed by the department of taxation.

(d) The absence of the certificate shall give rise to the presumption that the Lessee is not allowed

the sublease deduction. [Eff **OCT 01, 1998**] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-16.5)

§18-237-16.5-03 Deduction for sublease of real property or space. (a) General Rule. A Lessee who subleases real property or space shall be allowed a deduction from the amount of gross proceeds or gross income received from the Sublessee. The deduction shall be the total amount paid by the Lessee to the Lessor, subject to the requirements and allocations provided under section 237-16.5, HRS, and sections 18-237-16.5-03 to 18-237-16.5-06, at the maximum allowable rate. The allowable rate to be used in computing the deduction is as follows:

- (1) For gross proceeds or gross income paid in the months of October, November, and December, 1998, 0.125;
- (2) In calendar year 1999, 0.25;
- (3) In calendar year 2000, 0.375;
- (4) In calendar year 2001, 0.50;
- (5) In calendar year 2002, 0.625;
- (6) In calendar year 2003, 0.75; and
- (7) In calendar year 2004, and thereafter, 0.875.

Example 4: Lessor L leases real property X to lessee A for \$1,000 a year and lessee A subleases the same real property X under a written sublease to sublessee B for \$2,500 a year. B subleases the same real property to "sub-sublessee" C for \$2,500 a year.

A's deduction would be \$1,000 multiplied by the maximum allowable rate listed above. Using a maximum allowable rate of 0.875 (or 87.5 per cent), A's deduction would be \$875 ($\$1,000 \times 0.875$). A would be subject to a general excise tax of \$65 ($(\$2,500 - \$875) \times 4$ per cent tax rate).

B's deduction would be \$2,187.50 ($\$2,500 \times 0.875$). B would be subject to a general excise tax of \$12.50 ($(\$2,500 - \$2,187.50) \times 4$ per cent tax rate).

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L would be subject to a general excise tax of \$40 (\$1,000 x 4 per cent tax rate).

(b) Percentage leases. Where real property or space is leased under a percentage lease, the amount of gross proceeds or gross income received by the Lessor will vary from period to period because the amount paid by the Lessee to the Lessor is based upon a percentage of the gross sales or net profits of the Lessee's business. There may be a stipulated minimum lease amount. A percentage lease includes a percentage lease with a fixed minimum lease amount, a percentage lease with no minimum lease amount, and a combination percentage lease with a fixed minimum lease amount or percentage lease with no minimum lease amount, whichever is higher.

Example 5: Assume the same facts as Example 4 above except that A subleases to B for \$2,500 and 10 per cent of C's sales. B subleases to C for \$2,500 and 20 per cent of C's sales. If C's sales for the period were \$4,000, the percentage of sales would be \$400 (\$4,000 x 10 per cent) which would be added to the \$2,500 fixed minimum lease payment. \$2,900 (\$2,500 + \$400) would be paid by B to A and reported by A. Assuming a maximum allowable rate of 87.5 per cent, A's deduction would be \$875 (\$1,000 x 87.5 per cent). A would be subject to a general excise tax of \$81 ((\$2,900 - \$875) x 4 per cent tax rate).

Because C's sales for the period are \$4,000, the percentage of sales would be \$800 (\$4,000 x 20 per cent) which is added to the \$2,500 fixed minimum lease payment paid by C to B. \$3,300 (\$2,500 + \$800) would be reported by B. B's deduction would be \$2,537.50 (\$2,900 x 87.5 per cent). B would be subject to a general excise tax of \$30.50 ((\$3,300 - \$2,537.50) x 4 per cent tax rate).

L would be subject to a general excise tax of \$40
(\$1,000 X 4 per cent tax rate).

Example 6: Assume the same facts as Example 4 above except that A subleases to B for 10 per cent of C's sales with no fixed lease payment. B subleases to C for 20 per cent of C's sales with no fixed lease payment. If C's sales for the period were \$20,000, the percentage of sales would be \$2,000 (\$20,000 x 10 per cent) which would be paid by B to A and reported by A. Assuming a maximum allowable rate of 87.5 per cent, A's deduction would be \$875 (\$1,000 x 87.5 per cent). A would be subject to a general excise tax of \$45 ((\$2,000 - \$875) x 4 per cent tax rate).

Because C's sales for the period are \$20,000, the percentage of sales would be \$4,000 (\$20,000 x 20 per cent) which would be paid by C to B and reported by B. B's deduction would be \$1,750 (\$2,000 x 87.5 per cent). B would be subject to a general excise tax of \$90 ((\$4,000 - \$1,750) x 4 per cent tax rate).

L would be subject to a general excise tax of \$40
(\$1,000 X 4 per cent tax rate). [Eff **OCT 01, 1998**]
(Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-16.5)

§18-237-16.5-04 Allocation – sublease of less than one hundred per cent of the real property or space. (a) If the Lessee subleases less than one hundred per cent of the real property or space that was leased from the Lessor, the Lessee shall allocate the total amount of gross proceeds or gross income paid by the Lessee for that real property or space based upon the percentage of real property or space subleased, or the fair rental value as determined by the factors in section 18-237-16.5-06. The director of taxation may redetermine the amount of the Lessee's deduction under section 237-16.5(d), HRS, if the director finds that the basis for the allocation is not reasonable or that redetermination is necessary to prevent the avoidance of taxes. The total amount allocated by the Lessee to all subleases shall not exceed the total amount of gross proceeds paid by the Lessee to the Lessor.

(b) The Lessee's allocation may be based upon the percentage of the real property or space subleased by the Lessee when it is reasonable under the circumstances.

- (1) The percentage of real property or space subleased by the Lessee shall be multiplied by the amount of gross proceeds or gross income paid by the Lessee to the Lessor for the real property or space.
- (2) The product of the preceding multiplication shall be deducted by the Lessee from the amount of gross proceeds or gross income received for subleasing the real property or space.

Example 7: Lessor L leases real property XYZ, which is divided into spaces X, Y, and Z, to lessee A for \$20,000 (space X at \$10,000 + space Y at \$5,000 + space Z at \$5,000). Lessee A subleases less than one hundred percent of Spaces X (50 per cent) and Y (40 per cent). If reasonable under the circumstances, Lessee A may allocate the \$20,000 paid to Lessor L and compute

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its tax in the following manner.

Space X

- Step (1) A subleases fifty per cent of Space X for \$7,000. The percentage of Space X subleased (50 per cent) multiplied by the amount of rent paid by A to L for Space X (\$10,000) is \$5,000.
- Step (2) Assuming a maximum allowable rate of 0.875, A's deduction would be \$4,375 ($\$5,000 \times 87.5$ per cent). A would be subject to a general excise tax of \$105 ($(\$7,000 - \$4,375) \times 4$ per cent tax rate) on the income from subleasing fifty per cent of Space X.

Space Y

- Step (1) A subleases forty per cent of Space Y for \$3,000. The percentage of Space Y subleased (40 per cent) multiplied by the amount of rent paid by A to L for Space Y (\$5,000) is \$2,000.
- Step (2) Assuming a maximum allowable rate of 0.875, A's deduction would be \$1,750 ($\$2,000 \times 87.5$ per cent). A would be subject to a general excise tax of \$50 ($(\$3,000 - \$1,750) \times 4$ per cent tax rate) on the income received from subleasing forty per cent of Space Y.

L would be subject to a general excise tax of \$800 ($\$20,000 \times 4$ per cent tax rate).

(c) The Lessee's allocation shall be based upon fair rental value as determined by the factors in section 236-16.5-06 if an allocation based upon the percentage of the real property or space subleased is not reasonable under the circumstances.

- (1) A ratio whose numerator is the fair rental

value of the real property or space subleased by the Lessee and whose denominator is the fair rental value of all the real property or space leased by the Lessee shall be multiplied by the amount of gross proceeds or gross income paid by the Lessee to the Lessor for the real property or space.

- (2) The product of the preceding multiplication shall be deducted by the Lessee from the amount of gross proceeds or gross income received for subleasing the real property or space.

Example 8: Lessor L leases real property Y to lessee A for \$5,000 a month. Y consists of ground floor retail real property (which has a fair rental value of \$7,500) and upper floor office real property (which has a fair rental value of \$2,500) equal in size to the ground floor retail real property. Lessee A subleases only the upper floor office real property to sublessee B for \$2,500 a month.

Step (1) The property subleased represents twenty five per cent of the fair rental value of real property Y ($\$2,500$ divided by $(\$2,500 + \$7,500)$). A's deduction is $\$1,250$ (25 per cent multiplied by $\$5,000$ (the gross income paid to L for real property Y)).

Step (2) Assuming a maximum allowable rate of 0.875, A's deduction would be $\$1,093.75$ ($\$1,250 \times 87.5$ per cent). A would be subject to a general excise tax of $\$56.25$ ($(\$2,500 - \$1,093.75) \times 4$ per cent tax rate).

L would be subject to a general excise tax of \$200

($\$5,000 \times 4$ per cent tax rate). [Eff **OCT 01, 1998**]
(Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-16.5)

§18-237-16.5-05 Allocation – Various real property or space with different rental values; sublease of one hundred per cent of the real property or space. If the Lessee leases from the Lessor various real property or space which has different rental values and the Lessee subleases the real property or space, the Lessee shall allocate the total amount of gross proceeds or gross income paid by the Lessee for all real property or space based upon the percentage of real property or space leased, or if not reasonable, the fair rental value as determined by factors in section 237-16.5-06 for each real property or space before the Lessee may compute the deduction under section 237-16.5(g), HRS.

Example 9: Lessor L leases real property XYZ, which is divided into spaces X, Y, and Z, to lessee A for \$10,000. Space X is fifty per cent of the entire real property and spaces Y and Z account for twenty-five per cent each of the real property. Lessee A allocates the gross proceeds paid to L based upon the percentage of space leased as follows: Space X (\$5,000), Space Y (\$2,500), and Space Z (\$2,500).

[Eff **OCT 01, 1998**] (Auth: HRS §§231-3(9), 237-8)
(Imp: HRS §237-16.5)

§18-237-16.5-06 Allocation based upon fair rental value. (a) The Lessee, in addition to the size, quality and location of the real property or space, shall consider the following factors when an allocation under section 18-237-16.5-04 or section 18-237-16.5-05 is required and the allocation based upon the percentage of the real property or space subleased is not reasonable under the circumstances.

- (1) Factors for vacant land.
 - (A) Current rents paid and asked for comparable vacant lands in the same area as of the date when the lease is executed; and
 - (B) The written opinion of a person knowledgeable about rental values for vacant lands, including a real estate appraiser certified under chapter 466K, HRS, or real estate broker licensed under chapter 467, HRS, with a knowledge of rental values for vacant lands.
- (2) Factors for apartment, hotel, and similar residential property.
 - (A) Number and size of the rooms planned to be leased, quality and condition of the building, existence of special services or facilities, and the influence of such amenities as a desirable view;
 - (B) Current rents paid and asked for comparable apartment, hotel, or similar residential property in the same area as of the date when the lease is executed; and
 - (C) The written opinion of a person knowledgeable about rental values for applicable apartment, hotel, or residential property, including a real estate appraiser certified under chapter 466K, HRS, or real estate broker

- properly licensed under chapter 467, HRS, with a knowledge of rental values for the applicable apartment, hotel, or residential property.
- (3) Factors for store, office, and other commercial property.
 - (A) For a retail store, consider sales volume, existence of nearby competition, and the availability of public transportation and parking facilities;
 - (B) Current rents paid and asked for comparable stores, offices, or other commercial properties in the same area as of the date when the lease is executed; and
 - (C) The written opinion of a person knowledgeable about rental values for applicable store, office, and commercial property, including a real estate appraiser certified under chapter 466K, HRS, or real estate broker properly licensed under chapter 467, HRS, with a knowledge of rental values for the applicable store, office, and other commercial property.
 - (4) Factors for mining, manufacturing, and other industrial property.
 - (A) Gross and net area, ceiling height, physical condition of the real property, availability of parking, loading and other service areas, access to transportation facilities, and the labor market in the area;
 - (B) Current rents paid and asked for comparable mining, manufacturing, and other commercial properties in the same area as of the date when the lease is executed; and

- (C) The written opinion of a person knowledgeable about rental values for applicable mining, manufacture, and other industrial properties, including a real estate appraiser certified under chapter 466K, HRS, or real estate broker licensed under chapter 467, HRS, with a knowledge of rental values for mining, manufacturing, and other industrial property.
- (5) Factors for farms and ranches.
 - (A) For a farm, kinds of crops for which the land is suitable, and the probable yield.
 - (B) Current rents paid and asked for comparable farms and ranches in the same area as of the date when the lease is executed; and
 - (C) The written opinion of a person knowledgeable about rental values for applicable farms and ranches, including a real estate appraiser certified under chapter 466K, HRS, or real estate broker properly licensed under chapter 467, HRS, with a knowledge of rental values for farms and ranches.

(b) This listing of factors is not exclusive. If these factors do not result in a reasonable allocation of the gross proceeds or gross income paid by the Lessee, the Lessee may use or the department of taxation may require the use of other factors.

[Eff **OCT 01, 1998**] (Auth: HRS §§231-3(9), 237-8)
(Imp: HRS §237-16.5)

§18-237-16.5-07

§18-237-16.5-07 Burden of proof on the taxpayer.

The taxpayer has the burden of providing evidence satisfactory to the department of taxation that the taxpayer qualifies to be taxed under section 237-16.5, HRS, instead of section 237-13(10), HRS. If the taxpayer qualifies to be taxed under section 237-16.5, HRS, the taxpayer has the burden of providing evidence satisfactory to the department that the taxpayer qualifies for the deduction for the sublease of the

real property or space. [Eff **OCT 01, 1998**] (Auth:
HRS §§231-3(9), 237-8) (Imp: HRS §237-16.5)

Department of Taxation

Amendments to chapter 18-237, Hawaii Administrative Rules (HAR), on the Summary page, dated August 17, 1998, were adopted on August 17, 1998, following a public hearing held on August 17, 1998, after public notice was published in the Honolulu Advertiser, the Honolulu Star-Bulletin, the Garden Island, the Maui News, and the Hawaii Tribune-Herald on July 17, 1998.

These amendments shall take effect on October 1, 1998, after filing with the Office of the Lieutenant Governor.

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Ray K. Kamikawa
Director of Taxation

APPROVED:

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Benjamin J. Cayetano
Governor
State of Hawaii

9/29/98

Date: _____

APPROVED AS TO FORM:

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Deputy Attorney General

OCT 01 1998

Filed