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HOUSE COMMITTEE ON ECONOMIC REVITALIZATION & BUSINESS

TESTIMONY OF THE DEPARTMENT OF TAXATION REGARDING HB SB 1107, SD 1 RELATING TO GENERAL EXCISE TAX

TESTIFIER: FREDERICK D. PABLO, DIRECTOR OF TAXATION (OR
DESIGNEE)
COMMITTEE: ERB
DATE: MARCH 22, 2011
TIME: 8:00AM
POSITION: OPPOSED

This measure's stated intent is to expand the common paymaster exemption; however, it also appears to expand the related entities exemption.

The Department of Taxation (Department) is opposed.

It is the Department's understanding that the bill's intent is to expand the related entities exemption under HRS § 237-23.5 in two ways: (1) by diluting the requirements in order for two entities to be deemed "related," and (2) by expanding the types of services which qualify for the exemption.

The Department is opposed to expanding the related entities exemption in either of these two ways. However, if it is the committee's intent to move the bill forward, the Department recommends the bill be entirely re-written, using workable language which explains exactly to what extent the committee would like the common ownership requirements diluted and to what extent it wants the definition of "services" expanded. The Department also questions the need to expand the very narrow provisions of the federal common paymaster definition. At a time when the Legislature is considering eliminating existing exemption, it would not be prudent to expand this existing exemption.

From: Tina Desuacido [tina500@juno.com]
Sent: Monday, March 21, 2011 9:26 AM
To: ERBtestimony
Subject: Tax Foundation Testimony
Attachments: s0318e11.pdf; s0755e11.pdf; s1107d11.pdf

TRANSMISSION OF TESTIMONY

DATE: Monday, March 21, 2011

TO: House Committee on Economic Revitalization & Business

FROM: Tax Foundation of Hawaii

Total Pages 9

FOR: Rep. Angus McKelvey, Chair

Testifier: Lowell L. Kalapa, President - Tax Foundation of Hawaii

(Mr. Kalapa will not appear in person at the hearing.)

Date of Hearing - Tuesday, March 22, 2011

Position: Comments

Time of Hearing - 8:00 am

SB 318, SD-2 - Relating to Business Development in Hawaii (5 pages)

SB 755, SD-2 - Relating to Economic Development (2 pages)

✓ SB 1107, SD-1 - Relating to the General Excise Tax (2 pages)

Number of copies - 4

Thank you.

TAXBILLSERVICE

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TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: GENERAL EXCISE, Expand common paymaster exemption

BILL NUMBER: SB 1107, SD-1

INTRODUCED BY: Senate Committee on Ways and Means

BRIEF SUMMARY: Amends HRS section 237-23.5 to provide that the general excise tax shall not be applicable to amounts received by one related entity under IRC section 267 to another IRC section 267 entity. The chapter shall not apply to amounts received by a common paymaster that are disbursed as remuneration to employees of two or more related persons where the common paymaster is making such remunerations on behalf of the related persons. Such amounts received or disbursed by the common paymaster shall include payments of payroll taxes and employee benefits that the common paymaster is making on behalf of the related persons and are payments which the employees are being remunerated.

Requires each related person using a common paymaster or multiple common paymasters to keep separate payroll records and other documentation required to prove the existence of concurrent employment. The records and documents shall be available for inspection by the director of taxation during normal business hours.

Defines "common paymaster" and "related persons" for purposes of the measure.

Adds a new paragraph to HRS section 237-24.7 to exempt from the general excise tax, amounts received by a related or indirectly related management entity, as defined under section 237-23.5, taking into account the attribution rules under section 267, Internal Revenue Code, managing the business of the affiliates, including salaries, wages and related taxes, vacation pay, sick pay, and pensions and insurance paid out to or on behalf of employees of the related management company and reimbursed by the related company for those operating expenses.

The amendment made to HRS section 237-24.7 shall not be repealed when that section is reenacted on December 31, 2014 by Act 91, SLH 2010.

EFFECTIVE DATE: July 1, 2010

STAFF COMMENTS: Currently the common paymaster general excise tax exemption is applicable to: (1) an affiliated group of corporations within the meaning of section 1504 (with respect to affiliated group defined) of the federal Internal Revenue Code of 1986, as amended; (2) a controlled group of corporations within the meaning of section 1563 (with respect to definitions and special rules) of the federal Internal Revenue Code of 1986, as amended; (3) those entities connected through ownership of at least **eighty** percent of the total value and at least **eighty** percent of the total voting power of each such entity (or combination thereof), including partnerships, associations, trusts, S corporations, nonprofit corporations, limited liability partnerships, or limited liability companies; and (4) any group or

combination of the entities described in paragraph (3) constituting a unitary business for income tax purposes.

While the proposed measure expands the common paymaster provisions under HRS section 237-23.5 to include IRC section 267 entities and this draft also adds a new paragraph to HRS section 237-24.7, it would be preferable to delineate these amendments under the new paragraph rather than to expand the existing provisions under HRS section 237-23.5 where the reimbursement of payroll and employee benefits by a related company is addressed. It should be noted that when the common paymaster provisions were established by Sections 1504 and 1563 in 1988, the eighty percent ownership was a critical test as to the applicability of the exemption. To now dilute that test raises questions about the appropriateness of the exemption. Thus, it would be best to eliminate the amendment to HRS 237-23.5 and clean up the language in the new paragraph (10) of HRS 237-24.7.

If, in fact, this is a simple reimbursement of costs for payroll and employee benefits without any additional consideration, then the transaction is already exempt under HRS Sec. 237-20, provided there is no additional fee or remuneration for the disbursing paymaster for providing that service. Therefore, it appears that these particular related companies are indeed compensating the paymaster for this service and, therefore, are seeking this special treatment.

Digested 3/21/11

Testimony to the House Committee on Economic Revitalization & Business
Tuesday, March 22, 2011
8:00 a.m.
State Capitol - Conference Room 312

RE: SENATE BILL NO. 1107 SD1 RELATING TO THE GENERAL EXCISE TAX

Chair McKelvey, Vice Chair Choy, and members of the committee:

The Chamber of Commerce of Hawaii ("The Chamber") supports SB 1107 SD1 relating to the General Excise Tax.

The Chamber is the largest business organization in Hawaii, representing more than 1,100 businesses. Approximately 80% of our members are small businesses with less than 20 employees. As the "Voice of Business" in Hawaii, the organization works on behalf of its members, which employ more than 200,000 individuals, to improve the state's economic climate and to foster positive action on issues of common concern.

Many businesses consist of a group of entities under common ownership. Employees of the business often do work for more than one of the entities, but for sake of convenience, one of the entities is designated as "paymaster" to handle payroll. The paymaster pays the employee salaries on behalf of all of the entities, and receives reimbursement from the other entities for their allocable shares.

Under current law, the paymaster entity is usually subject to GET on the reimbursements it receives from the related entities, even though it realizes no real benefit from those amounts, but simply passes them on to the employees. This creates an unsolvable dilemma for Hawaii businesses -- they must either bear the administrative cost of having multiple entities handle payroll, or bear the increased cost of GET on the intercompany reimbursements. There is no justification for this tax result. It just creates inefficiency for Hawaii businesses and discourages job creation.

HB 848 HD2 would make the common paymaster exemption less restrictive, and make it more applicable to the general business community in Hawaii. Because HB 848 would remove an inefficiency in current tax law, we support this measure

From: Darryl Wong [dwong@99imperial.net]
Sent: Monday, March 21, 2011 9:58 AM
To: ERBtestimony
Subject: SB 1107

Dear Committee members,

My name is Darryl Wong and I presented before your committee the proposed changes to SB1107 SD1. I submitted as well the below changes on HB 848 HD2 in order that both the House and Senate Bills introduced matched one another. We do not feel this bill will take away revenues from the State as this is more a clarification of how many family businesses in Hawaii interpret the meaning of the State law. As years go on and families pass on their businesses to their sons and daughters or even grand children, ownership interests of companies change so there is sometimes not a direct ownership relationship between companies but an indirect relationship in ownership. We feel this change merely clarifies the law so local family businesses are not penalized unfairly by the Tax Departments interpretation of the law. Before the Bill crossed over, we attempted to clarify our proposed change to the language of the Bill but were unable to do so hence we are making the request here so both what has been presented to both House and Senate match.

Our proposed language change greatly simplifies the purpose and intent of the bill by adding paragraph 10 to Section 237-24.7. For the purposes of this 2011 session, our desire is to ensure that only salaries are protected under the law as it pertains to reimbursable expenses for a common paymaster. Attached is our marked-up copy that illustrates our request for the following:

1. Delete the entirety of Section 2 as it is written.

2. Add a new Section 2 as follows:

SECTION 2. Section 237-24.7, Hawaii Revised Statutes, is amended to read as follows:

"§237-24.7 Additional amounts not taxable. In addition to the amounts not taxable under section 237-24, this chapter shall not apply to:

(1) Amounts received by the operator of a hotel from the owner of the hotel or from a time share association, and amounts received by the suboperator of a hotel from the owner of the hotel, from a time share association, or from the operator of the hotel, in amounts equal to and which are disbursed by the operator or suboperator for employee wages, salaries, payroll taxes, insurance premiums, and benefits, including retirement, vacation, sick pay, and health benefits. As used in this paragraph:

"Employee" means employees directly engaged in the day-to-day operation of the hotel and employed by the operator or suboperator.

"Hotel" means an operation as defined in section 445-90 or a time share plan as defined in section 514E-1.

"Operator" means any person who, pursuant to a written contract with the owner of a hotel or time share association, operates or manages the hotel for the owner or time share association.

"Owner" means the fee owner or lessee under a recorded lease of a hotel.

"Suboperator" means any person who, pursuant to a written contract with the operator, operates or manages the hotel as a subcontractor of the operator.

"Time share association" means an "association" as that term is defined in section 514E-1;

(2) Amounts received by the operator of a county transportation system operated under an operating contract with a political subdivision, where the political subdivision is the owner of the county transportation system. As used in this paragraph:

"County transportation system" means a mass transit system of motorized buses providing regularly scheduled transportation within a county.

"Operating contract" or "contract" means a contract to operate and manage a political subdivision's county transportation system, which provides that:

(A) The political subdivision shall exercise substantial control over all aspects of the operator's operation;

(B) The political subdivision controls the development of transit policy, service planning, routes, and fares; and

(C) The operator develops in advance a draft budget in the same format as prescribed for

agencies of the political subdivision. The budget must be subject to the same constraints and controls regarding the lawful expenditure of public funds as any public sector agency, and deviations from the budget must be subject to approval by the appropriate political subdivision officials involved in the budgetary process.

"Operator" means any person who, pursuant to an operating contract with a political subdivision, operates or manages a county transportation system.

"Owner" means a political subdivision that owns or is the lessee of all the properties and facilities of the county transportation system (including buses, real estate, parking garages, fuel pumps, maintenance equipment, office supplies, etc.), and that owns all revenues derived therefrom;

(3) Surcharge taxes on rental motor vehicles imposed by chapter 251 and passed on and collected by persons holding certificates of registration under that chapter;

(4) Amounts received by the operator of orchard properties from the owner of the orchard property in amounts equal to and which are disbursed by the operator for employee wages, salaries, payroll taxes, insurance premiums, and benefits, including retirement, vacation, sick pay, and health benefits. As used in this paragraph:

"Employee" means an employee directly engaged in the day-to-day operations of the orchard properties and employed by the operator.

"Operator" means a producer who, pursuant to a written contract with the owner of the orchard property, operates or manages the orchard property for the owner where the property contains an area sufficient to make the undertaking economically feasible.

"Orchard property" means any real property that is used to raise trees with a production life cycle of fifteen years or more producing fruits or nuts having a normal period of

development from the initial planting to the first commercially saleable harvest of not less than three years.

"Owner" means a fee owner or lessee under a recorded lease of orchard property;

(5) Taxes on nursing facility income imposed by chapter 346E and passed on and collected by operators of nursing facilities;

(6) Amounts received under property and casualty insurance policies for damage or loss of inventory used in the conduct of a trade or business located within the State or a portion thereof that is declared a natural disaster area by the governor pursuant to section 209-2;

(7) Amounts received as compensation by community organizations, school booster clubs, and nonprofit organizations under a contract with the chief election officer for the provision and compensation of precinct officials and other election-related personnel, services, and activities, pursuant to section 11-5;

(8) Interest received by a person domiciled outside the State from a trust company (as defined in section 412:8-101) acting as payment agent or trustee on behalf of the issuer or payees of an interest bearing instrument or obligation, if the interest would not have been subject to tax under this chapter if paid directly to the person domiciled outside the State without the use of a paying agent or trustee; provided that if the interest would otherwise be taxable under this chapter if paid directly to the person domiciled outside the State, it shall not be exempt solely because of the use of a Hawaii trust company as a paying agent or trustee;

(9) Amounts received by a management company from related entities engaged in the business of selling interstate or foreign common carrier telecommunications services in amounts equal to and which are disbursed by the management company for employee wages, salaries, payroll taxes, insurance premiums, and

benefits, including retirement, vacation, sick pay, and health benefits. As used in this paragraph:

"Employee" means employees directly engaged in the day-to-day operation of related entities engaged in the business of selling interstate or foreign common carrier telecommunications services and employed by the management company.

"Management company" means any person who, pursuant to a written contract with a related entity engaged in the business of selling interstate or foreign common carrier telecommunications services, provides managerial or operational services to that entity.

"Related entities" means:

(A) An affiliated group of corporations within the meaning of section 1504 (with respect to affiliated group defined) of the federal Internal Revenue Code of 1986, as amended;

(B) A controlled group of corporations within the meaning of section 1563 (with respect to definitions and special rules) of the federal Internal Revenue Code of 1986, as amended;

(C) Those entities connected through ownership of at least eighty per cent of the total value and at least eighty per cent of the total voting power of each such entity (or combination thereof), including partnerships, associations, trusts, S corporations, nonprofit corporations, limited liability partnerships, or limited liability companies; and

(D) Any group or combination of the entities described in paragraph (C) constituting a unitary business for income tax purposes; whether or not the entity is located within or without the State or licensed under this chapter; [~~and~~]

(10) Amounts received by a related or indirectly related management entity, as defined under section 237-23.5, taking into account the attribution rules under section 267, Internal Revenue Code, as amended, managing the business of the affiliates, including salaries, wages and related taxes, vacation pay, sick pay, and pensions and insurance paid out to or on behalf of employees of the related management company and reimbursed by the related company for those operating expenses; and

3. Section 3 remains the same:

SECTION 3. Statutory material to be repealed is bracketed and stricken. New statutory material is underscored.

4. Section 4 includes language to prevent the repeal of the law, with an effective date change to July 2, 2011.

SECTION 4. This Act shall take effect on July 1, 2050; provided that the amendment made to section 237-24.7, Hawaii Revised Statutes, by section 3 of this Act shall not be repealed when that section is reenacted on December 31, 2014, by section 1 of Act 91, Session Laws of Hawaii 2010.

We thank you in advance for all your time and consideration of our request. Please feel free to contact me at 943-3106 should you have any questions or require further clarification.

Aloha,

Darryl P. Wong

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