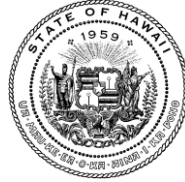


DAVID Y. IGE  
GOVERNOR

SHAN TSUTSUI  
LT. GOVERNOR



STATE OF HAWAII  
**DEPARTMENT OF TAXATION**  
P.O. BOX 259  
HONOLULU, HAWAII 96809  
PHONE NO: (808) 587-1540  
FAX NO: (808) 587-1560

MARIA E. ZIELINSKI  
DIRECTOR OF TAXATION

To: The Honorable Gilbert Kahele, Chair  
and Members of the Senate Committee on Tourism and International Affairs

Date: Wednesday, February 18, 2015  
Time: 2:45 P.M.  
Place: Conference Room 225, State Capitol

From: Maria E. Zielinski, Director  
Department of Taxation

Re: S.B. 1306, Relating to Real Property

The Department of Taxation (Department) has serious concerns regarding S.B. 1306 and provides the following comments for your consideration.

S.B. 1306 permits a taxpayer who provides transient accommodations on real property leased from a related entity to claim a General Excise Tax (GET) deduction from the amount of gross proceeds or gross income received from its sublease of the real property. The measure takes effect on July 1, 2015.

This measure expands the GET sublease deduction allowed under Hawaii Revised Statutes (HRS) section 237-16.5. Under current law, the sublease deduction may be taken where the lessee enters into a written sublease with another tenant. When this occurs, the lessee may exclude up to seven-eighths of the amount that the lessee pays in rent to the lessor from the gross receipts that the lessee receives from its sublessee. This measure expands the sublease deduction by treating the furnishing of transient accommodation as a sublease of property regardless of whether or not there is written agreement, but only where the lessee leases the property from a related entity.

More specifically, this measure extends the sublease deduction to the amounts that are paid by hotel guests in exchange for the renting of a room, by deeming such rentals to be a sublease of property to which the subleasing deduction would also apply. When a guest stays at a hotel or other accommodation, the guest is not only paying for the right to stay in that room, but also for a myriad of other services, including the concierge, housekeeping, electricity, water, security and a host of other services. These items have never been allowed as a deduction in computing taxable receipts under the sublease deduction. Because this measure treats all of the amounts received from the guests as subject to the sublease deduction, it would encourage the operator of the transient accommodations to build other things into the room price which might otherwise be billed separately, such as internet access, meals, and the like.

The Department notes that the expansion of the sublease deduction proposed in S.B.1306 is limited to related entities. This related entities limitation would create an uneven playing field for similarly situated taxpayers solely on the basis of whether or not the property is leased from a related party. GET would be imposed on one transaction but not another simply because the latter was between related entities. If the Committee wishes to adopt this measure, the Department suggests that this measure be expanded to cover unrelated entities as well.

The Department believes that this measure could also lead to significant violations of consumer protection law because the GET is generally passed on to the consumers, including hotel guests, and it is the general industry practice to do so. However, it is unlawful to pass on the GET to a customer when certain amounts would be exempted from tax because of this deduction. It is unclear how a taxpayer claiming the exemption could apply the sublease deduction to the furnishing of transient accommodations because the taxpayer would not be able to determine the point at which it would need to start to pass on the tax, or how it could determine the proper rate it should be charged to all guests over the course of its tax year since it would not know at the outset how much total income it would receive.

For example, suppose a hotel operator pays the landlord \$1,000 during the year. The sublease deduction is limited to \$875. Any amounts which exceed \$875 would be taxed at the retail GET rate of 4% (4.5% on Oahu). If guests rented rooms over the course of a year for rents totaling \$1,000, then GET properly is imposed on the \$125 in excess of the \$875 limit on the sublease deduction. This is a highly simplified illustration that does not begin to cover the complex nature of the hotel industry. There is no practical way that this deduction can be administered by the taxpayers themselves, and is likely to result in noncompliance such as misreporting and underpayment, or alternatively, overcharging to the guests with the taxpayer keeping the excess funds since it is the guests that ultimately pay the tax.

It should be noted that a significant number of hotel owners have formed public hotel Real Estate Investment Trusts (REITs). REITs are essentially tax-driven vehicles that are subject to a complicated and detailed tax regulatory structure. One of a REIT's central activities is the buying, holding and selling of "income-producing real estate". A major tax benefit of a REIT is that it is allowed a dividends paid deduction for the dividends that it pays in determining the amount of income that is subject to income tax. For all practical purposes, REITs are exempt from taxation even though they are treated as a corporation for tax purposes, provided that they distribute at least 90% of their income to their unit holders. Unless the unit holder is subject to Hawaii income taxes, a REIT will pay no Hawaii income tax.

Because of this significant tax benefit, the Internal Revenue Service rules governing REITs impose strict limitations on the income and activities of REITs. A REIT must comply with the so-called income test, which requires that at least 75 percent of its gross income be from rents from real property, interest on mortgages financing real property or from sales of real estate. Revenue from hotel operations does not satisfy this test and is unrelated business income (UBI). In addition, a REIT may not directly perform many services related to the management

or operation of the hotel property or business because income from these services is also considered UBI.

The REIT Modernization Act of 1999 (RMA) created the Taxable REIT Subsidiary (TRS), which allows a REIT to offer a more complete range of services to its tenants without jeopardizing its status as a REIT. To comply with the income test and avoid engaging in prohibited, non-real-estate-related activities, the typical hotel REIT leases the hotel assets to a TRS, which effectively converts the REIT's prohibited hotel revenue into permissible rental income.

TRS's are subject to the corporate income tax, but not to the regular REIT diversification tests. Although securities of a single issuer (other than another REIT) may generally constitute no more than 5 percent of a REIT's assets, securities of one or more TRS's may constitute up to 20 percent of a REIT's assets as measured by fair market value. Thus, REITs are allowed to own, directly or indirectly, up to 100% of the stock of a TRS that can engage in businesses previously prohibited to a REIT, subject to certain limitations. In particular, these provisions permit a hotel REIT to own a TRS that leases hotels from the REIT, rather than requiring the lessee to be a separate, unaffiliated party. However, hotels leased to a REIT-affiliated TRS must be managed by an unaffiliated third party (i.e., a true third-party hotel manager).

To avoid abuse, the RMA placed limits on the amount of interest and rents that a TRS can pay to a parent REIT and on what it could charge tenants for its services. For example, a TRS may deduct interest paid to parent REIT only if the debt to-equity ratio of the TRS is at most 1.5, or if the ratio of its interest payments to its net income before interest, net operating losses, and depreciation (i.e., the inverse of its interest coverage ratio) is at most 0.5. (IRC section 163(j)). Similarly, for rents paid by a TRS to a parent REIT to qualify as rents from real property for purposes of the 95-percent and 75-percent gross income tests, a TRS may rent no more than 10 percent of any property from a parent REIT and must pay rent comparable to that of other tenants. A 100-percent excise tax is levied on income from certain transactions between a parent REIT and its TRS that are found to be non-arm's length.

The lease between the REIT and the TRS must also be a true lease with typical lease obligations on the part of the TRS. The lease cannot be a service contract or joint venture under the guise of a lease. Accordingly, a REIT's possessory rights must be subject to the tenant's leasehold rights, and the tenant must have all of the benefits and risks of hotel operations. The true REIT lease will often provide for typical periodic fixed and percentage rent payments. The fixed rent payments must be paid without regard to the success or failure of the hotel. Percentage rent must be based on gross revenue, rather than profit or net income. The percentage rent figure is set at lease execution (like a typical lease), and cannot be renegotiated if the changes are based on profit or net income. The duration of the lease is another critical factor.

The Department is deeply concerned that this measure allows a REIT and its related entities to substantially reduce the amount of GET paid to the State, while at the same time also paying no income tax. This will be because under this measure, the TRS will be able to

substantially reduce its GET exposure, while minimizing any income taxes paid by inflating the expenses of the TRS by inflating the lease rent paid, costs of services paid to related entities, etc. The REIT meanwhile will have no income tax liability if it pays out at least 90% of its income as dividends, and as the unit holders are not likely to be in Hawaii, such dividends will also escape income taxation.

Thank you for the opportunity to provide comments.

# TAXBILLSERVICE

126 Queen Street, Suite 304

TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: GENERAL EXCISE, Transient accommodation sublease deduction

BILL NUMBER: SB 1306; HB 1327 (Identical)

INTRODUCED BY: SB by Kouchi by request; HB by Souki

EXECUTIVE SUMMARY: Applies the “sublease deduction” in HRS section 237-16.5 in the situation where the taxpayer leases real property from a related entity and furnishes transient accommodations on that property. The concept is consistent with the depyramiding philosophy that the sublease deduction is trying to implement, and is justifiable whether or not the taxpayer and the lessor are related entities.

BRIEF SUMMARY: Amends HRS section 237-16.5 to provide that the furnishing of a transient accommodation on real property that the taxpayer leases from a related entity shall qualify for the 0.5% reduced rate on real property leasing transactions. The furnishing of a transient accommodation shall be considered as made under a sublease, regardless of whether the arrangement is made in writing.

EFFECTIVE DATE: July 1, 2015

STAFF COMMENTS: Sales taxes in most states leave rent alone, but our General Excise Tax (GET) taxes it. Before the late 1990’s, both the lessor and the sublessor had to pay the full retail tax amount on the rent they respectively received, meaning that although there was only one tenant on the particular piece of property, sometimes a homeowner, sometimes a small business, 4% tax was imposed several times: when the tenant paid his landlord, when that landlord paid the person it was renting from, and so on up the chain up to the ultimate owner. (By the way, even if the owner is a charity - a church or a school, for example - GET is still imposed.)

To deal with this problem, a “Sublease Deduction” was enacted in 1997. It says that if a person is both renting real property from a landlord and then subleasing it, then the person, although paying 4% tax on the rent received, gets a deduction worth 3.5% of the rent paid. The lessor further up the chain pays 4% of that rent, making the effective tax rate on the first tier rent 0.5%, the same GET rate we normally apply to wholesale sales. The law now applies to written leases of real property.

This bill would explicitly provide that this sublease deduction will be allowed even if the “sublessor” is a hotel. Certainly the hotel is being paid for the use of its real property; the guests need to rest their heads somewhere at night. But there is also a significant service element; hotel guests receive front desk services, housekeeping, and other amenities that typical rentals don’t come with. The issue is whether that should matter. If the philosophy behind the 1997 act is to prevent retail rate GET from applying to the same use of the same real property, the proposal is consistent with that philosophy. Hoteliers have to pay GET on what they get for their room nights just like any other renters. If the hotel happens to be leasing its space from a large landowner, why should the state be allowed a second bite at the proverbial apple?

Interestingly, the issue of wholesale services in general was examined by the 1987-1989 Tax Review Commission, at a time when the 0.5% rate applied to very few wholesale services. The Commission recommended adopting the 0.5% rate for more wholesale service transactions (which actually happened in 2000), and also recommended that the wholesale services concept should be extended to the leasing of real property. It certainly looks like that Commission would have had no problem with treating transient accommodation rentals the same as other rentals.

Technical issues exist, of course. It may be argued that a hotelier shouldn't be allowed the sublease deduction to the extent that its rooms are vacant, which makes sense, and no hotelier has 100% occupancy. But that argument should not be morphed into a reason for disallowing the deduction altogether. We have retail rate GET being piled on top of retail rate GET for occupying the same piece of real estate, and that screams for at least some relief.

This measure would extend the deduction for real property leasing transaction in the case where a transient accommodation is on real property leased from a related entity, which would be the case if a REIT is the lessor and a taxable REIT subsidiary operates the hotel. It would appear that the adoption of this measure is justified whether or not the lease is from a related entity.

Digested 2/10/15

# Crockett & Associates

Robert D. Crockett  
23504 Lyons Avenue, No. 401  
Santa Clarita, California 91321  
323-487-1101  
323-843-9711 fax  
bob@bobcrockettlaw.com

February 10, 2015

Committee on Tourism and International Affairs  
Sen. Gilbert Kahele, Chair  
Sen. J. Kalani English, Vice Chair  
The Senate  
(Regular Session 2015)  
Conference Room 225  
State Capitol  
415 South Beretania Street

Re: Proposal to amend the sublease deduction of HRS § 237-16.5; SB 1306;  
Wednesday Feb. 18, 2015 Committee Hearing

Dear Mr. Chair and Mr. Vice Chair:

I am a California lawyer who represents Host Hotels & Resorts, L.P., a Hawaii General Excise Tax taxpayer. Host supports the passage of SB 1306. The House Bill proposes amendments to HRS § 237-16.5. Host offers this letter as testimony in favor of SB 1306, which would reduce the pyramiding of taxation upon businesses which own and lease hotels through affiliates.

Host is a Real Estate Investment Trust ("REIT")<sup>1</sup> which owns and leases through affiliates three hotels in Hawaii: the Hyatt Regency Maui Resort & Spa, The Fairmont Kea Lani and the Hyatt Place Waikiki Beach. Host affiliates hire independent third-party managers to operate hotels and collect revenue. The affiliates then pay rent to other Host affiliates.

---

<sup>1</sup> Congress established REITs in 1960 to offer small investors and pension plans the opportunity to invest in real estate properties without all the difficulties of managing real property. Although Host happens to be a REIT, the proposed legislation is designed address the inequities of double taxation when money is exchanged between a hotel owner and a hotel operator when both are affiliates in the same business organization.

There are two basic tax systems in Hawaii which affect hotels. One is the Transient Accommodations Tax ("TAT"), which is a tax imposed upon revenue received from hotel guests. The other is the General Excise Tax ("GET"), which imposes a tax on gross revenue from all sources, including hotel guests. The proposed SB 1306 would amend only the GET rules in order the pyramiding of GET in structures similar to those implemented by Host. The proposed SB 1306 does not operate to give hotels "a break" because they are taxed under both the TAT and GET regimes. But, as explained below, SB 1306 would make the GET structure consistent with the TAT structure in the way the TAT treats hotel guests.

Host is a long-term investor committed to increasing the value of its properties. Since Host's purchase of the Hyatt Regency Maui Resort & Spa in 2003, Host has invested more than \$165 million in its three hotel properties; in the last two years alone, Host invested almost \$56 million. Additionally, Host, in partnership with Hyatt Residential Group, invested more than \$150 million to open a new 131-unit timeshare on land adjacent to the Hyatt Regency in December 2014.

Because some hotel owners, like Host, use affiliates to own, lease and hire managers, there are multiple opportunities for the GET to apply to a revenue stream. In Host's case, the 4% GET applies twice to Host's hotel revenue: First, when the guest pays his or her room charges, and second when the hotel lessor pays rent on the hotel to another Host affiliate.

HRS § 237-16.5, in its current form, provides double taxation relief to a tenant which also receives sublease income. HRS § 237-16.5 allows the subtenant to deduct 87.5% of the rent it pays to its landlord from the subrent it receives from its subtenants. The Legislature's reason for this deduction was to mitigate double taxation, or pyramiding, upon the same rental revenue source.

SB 1306 treats a hotel affiliate, which hires a manager and which pays rent to another affiliate, like a tenant. SB 1306 treats hotel guests like subtenants so as to permit the current sublease deduction to apply to hotels which pay rent to corporate affiliates for the privilege of operating the hotel. SB 1306 would not provide for a sublease deduction to a hotel operator which does not lease the hotel from an affiliate.



We offer with this testimony an economic report from Dr. William Fox of the University of Tennessee. He has extensive economic expertise in Hawaii, having served as a consultant to the Department of Taxation. Dr. Fox explains the risks and burdens of double taxation under the GET structure, as well as the benefits of avoiding double taxation. Thus, SB 1306 simply clarifies that the sublease deduction applies to hotel room receipts, a result seemingly contemplated on the very form by which the GET is reported.

In *In re C. Brewer & Co., Ltd*, 65 Haw. 240, 649 P.2d 1155 (1982), the Hawaii Supreme Court upheld GET upon financial transfers between a parent and a wholly-owned subsidiary for provided services even though the transfers were mere book entries. The Court concluded that the net for GET was very wide and was intended to capture such transactions.

As a result of *In re Brewer*, the Legislature has enacted several GET exceptions for corporate affiliates that transfer money between themselves. For example, the Legislature passed HRS § 237-24.7(1), which exempts money sent from a hotel owner to a hotel operator to be used for wages, salaries, payroll taxes, insurance premiums, and benefits. HRS § 237-24.7(4) exempts money sent from an orchard owner to an orchard operator for the same sort of employee benefits. HRS § 237-24.7(9) also exempts payments between “related entities” involved in telecommunication services.

Further, HRS § 237-23.5 exempts “amounts received, charged or attributable to services furnished by one related entity to another related entity,” and “services” is broadly defined.

The proposed legislation of SB 1306 uses the same “related entity” definition of HRS § 237-23.5 to reduce the GET impact of a rent payment made between related entities.

We have noted above that the proposed legislation would have no effect upon the TAT structure (HRS §§ 237D-1 *et seq.*). In the TAT, a hotel guest is considered a tenant in real property. The TAT statute’s definitions say that “rental” “means the leasing or renting of living quarters or sleeping or housekeeping accommodations in hotels . . . or other places in which lodgings are regularly furnished to transients for a consideration, without transfer of the title of such property.” HRS §§ 237D-1. The form which the State uses to collect this tax refers to the tax as a tax upon rentals. HRS § 237D-8.5. Similarly, G-49, the form on which GET is reported and remitted (line 13) uses this

terminology. The proposed legislation would make the GET consistent with TAT, as the TAT statute treats the hotel guest as one who pays rent.

Therefore, the proposed legislation would make the GET treatment of hotels consistent with the TAT treatment – a guest is a tenant who pays rent. Moreover, the Legislature has endeavored to reduce the unfairness of double taxation, particularly upon revenue streams between related entities. SB 1306 seeks the same treatment for a hotel lessor and a hotel lessee that are related affiliates. The elimination of double taxation of hotel rental revenue generated between hotel corporate affiliates will encourage continued economic investment in Hawaii's tourism economy.

Very truly yours,

  
Robert D. Crockett  
Crockett & Associates

00067 legis

# GENERAL EXCISE TAX PYRAMIDING IN HAWAII

---

*Prepared by*

William F. Fox  
*Ergen Professor of Business*  
*The University of Tennessee*

January 22, 2015

## Table of Contents

|  |    |
|--|----|
| Introduction .....   | 1  |
| Understanding the GET .....  | 1  |
| Figure 1: State Sales Tax Base as a Percent of Personal Income, 2012 ..... | 3  |
| Defining Tax Pyramiding .....  | 3  |
| Extent of Pyramiding .....   | 4  |
| Table 1: State Sales Tax as Percent of Personal Income, FY2013 .....       | 4  |
| GET Pyramiding with Taxes on Hotels .....                                  | 5  |
| Figure 2: Hotel Pyramiding Example .....                                   | 7  |
| Problems with Tax Pyramiding .....   | 7  |
| Tourist Responses .....  | 8  |
| Business Responses .....   | 9  |
| Effects on Business Location and Production .....                          | 10 |
| GET Exemptions .....   | 10 |
| References .....   | 12 |

## Introduction

This paper examines pyramiding of the Hawaii General Excise Tax (GET), with special emphasis on the extent of pyramiding on certain types of hotel services and corporate structures. Previous research has concluded that pyramiding is a moderate issue for the average final good and services sold in Hawaii, but can be particularly important in some cases because of the GET structure. Hotels owned through REITs are subject to significant pyramiding because they separate the ownership of the real estate from the hotel operations into two legal entities, albeit owned by the same parent, which adds a second layer of GET on much of the hotel revenues. An example shown below suggests that the 4.0 percent GET results in at least 6.7 percent GET on the total room revenues received from hotel guests, and 7.0 percent compared with the base normally used in the U.S. for comparing sales taxes (net of tax). This pyramided tax is in addition to the 9.25 percent transient accommodations tax, which results in a total tax of 16.25 percent on room revenues received by hotels owned by Real Estate Investment Trusts (REITs).

The paper begins by providing a brief parallel between the GET and the sales taxes used by 44 other states. This is followed by sections defining tax pyramiding and discussing the extent of pyramiding on average. Then, an example of pyramiding with a REIT is given and a discussion of why pyramiding is harmful for the State of Hawaii and the U.S. economies is provided. Finally, examples of exemptions intended to reduce other egregious cases of pyramiding are provided.

## Understanding the GET

Sales taxes were developed at different times and in different contexts across the country, but they are widely understood as efforts to tax consumption. In fact, sales taxes are broadly expected to be forward shifted to buyers, whether the tax is imposed on the firm's gross receipts, as in Hawaii, or is legally a levy on consumers, as in a number of other states. Economists generally believe that the legal structure does not alter the incidence or intent of a tax.

The GET is a tax on the gross receipts of most firms operating in Hawaii.<sup>1</sup> The GET parallels the sales taxes that are levied in 44 other states and a wide range of local governments.<sup>2</sup> Though the GET is best thought of as a sales tax in the manner of taxes in other states, it differs in four key ways. First, the GET tax base (the set of transactions against which the tax is imposed) is much broader than any other states' (see Figure 1, which shows the sales tax bases as a percent of personal income for all states).<sup>3</sup> The GET's relatively broad base is evident in that it exceeds the size of the state's economy, whereas in the average state, the base is only about 35 percent of the state's economy. Hawaii's extensive taxation

---

<sup>1</sup> See Section 237, Hawaii Revised Statutes.

<sup>2</sup> See Fox (2002, 2006, and 2012) for detailed discussions of the GET.

<sup>3</sup> Personal income is a broad measure of the state economy that includes all income earned by all people in the state. The components include wages, rents, interest, dividends, transfer payments, fringe benefits, and proprietor's income.

of services and broad taxation of intermediate transactions are important reasons for the wider tax base.

Second, the standard GET rate of 4.0 percent<sup>4</sup> is low on national standards. Only Colorado has a lower sales tax rate among those states imposing the tax and six states have the same rate as Hawaii. The median state rate is 6 percent, and local governments in 38 states add a local sales tax rate.<sup>5</sup> Third, Hawaii levies a 0.5 percent rate against a very broad range of intermediate goods' transactions, an approach that is uncommon across the U.S. However, intermediate services' transactions are generally taxed at the full 4.0 percent rate, raising the extent of tax pyramiding for services. Also, a 0.5 percent tax is levied in Honolulu for rail construction.

Fourth, the legal structures differ to some extent across states. States impose their sales tax in two distinctive ways. Some states, such as Hawaii and New Mexico, impose their sales tax on the gross receipts of the recipient businesses. Many other states levy the sales tax directly on consumer purchases. Another set of states use a combination of the two approaches. These distinctions have some legal implications but do not alter the intent of the tax. Businesses collect and remit almost all of the tax in both cases, regardless of the legal structure for imposing the tax.

Consumption is done by households and individuals, and a tax imposed on consumption should be levied in a single stage only on final sales.<sup>6</sup> Intermediate goods and services are not consumed but instead are used in production.<sup>7</sup> So, a tax on these intermediate purchases parallels a tax on production not on consumption. Nonetheless, all states tax many intermediate purchases for reasons such as (1) it is difficult to distinguish consumers from businesses in many cases, (2) the legislated rate can be kept lower if intermediate goods and services are taxed, and (3) the revenues collected on intermediate goods are not transparent to voters.<sup>8</sup>

---

<sup>4</sup> Hawaii levies a 4.0 percent rate, but firms are required to pay tax on all revenues they collect, even if the revenue is intended as payment for the tax. Thus, the tax rate is 4.167 percent relative to the net of tax price paid by the buyer.

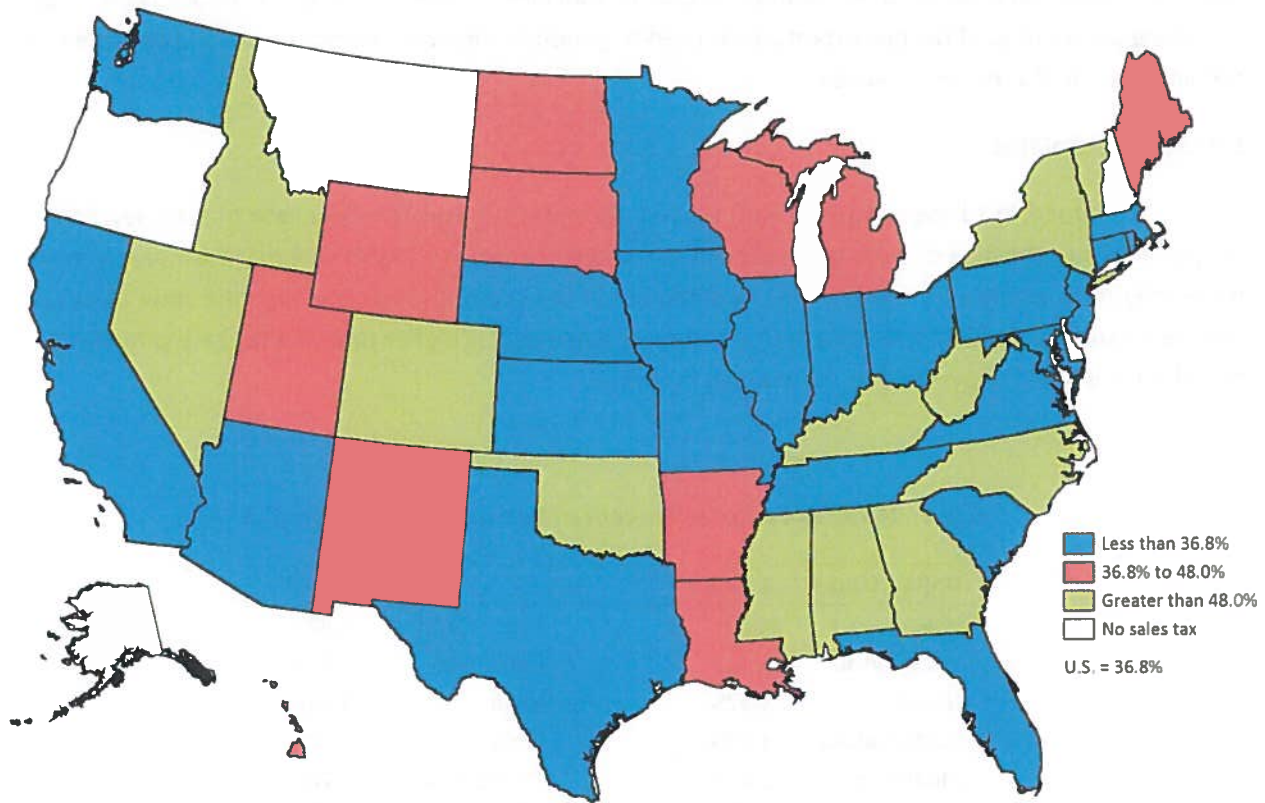
<sup>5</sup> Hawaii adds a 0.5 percent rate in Honolulu for light rail improvements. While levied in a single local area, the state retains 10 percent of the revenue and the rest is intended for light rail.

<sup>6</sup> A properly structured Value Added Tax (VAT) is a means of taxing consumption that involves collection of tax on value added at each step in the production chain. The VAT and sales taxes are conceptually trying to tax the same consumption base.

<sup>7</sup> Intermediate goods and services are employed in production regardless of whether they are direct components of manufacturing processes, are sold to final users, or are used for other purposes. They are used in production even if the expenditures are for desks, computers, and cellphones for use in business offices, because these inputs are still a necessary part of operating the business.

<sup>8</sup> The primary exception to the principal that sales taxes should not be imposed on intermediate transactions is when the final good is not taxed (see Bruce, Fox and Murray, 2003). This would seldom arise in Hawaii given the broad extent of consumer goods taxation.

Figure 1: State Sales Tax Base as a Percent of Personal Income, 2012



### Defining Tax Pyramiding

Tax pyramiding occurs when the tax is levied at more than one stage in the production chain, such as when the tax is on both intermediate transactions and final sales. Pyramiding increases the effective tax rate, which is the total tax implicit in the good or service divided by the final sales price, relative to the legislated rate. Tax pyramiding is broader than, but also includes, tax being paid on tax. Tax is paid on tax when an additional tax is levied on transactions' prices that include tax from earlier stages in the production chain. The tax on the final sale is often transparent to the buyer, but the pyramided portion of the tax is generally hidden, so the buyer does not realize that the price is partly the result of layered taxes. The pyramided tax, including both the initial GET and the additional amount from pyramiding will be forward shifted to consumers in higher prices. Some research even suggests that the price increase for consumers could be more than the amount of the tax.<sup>9</sup>

States, including Hawaii, make some effort to reduce the extent of tax pyramiding. Many allow exemptions for goods directly used in the manufacturing production process and for goods sold for resale. Hawaii also taxes many transactions at the 0.5 percent rate (and several other lower rates) to

<sup>9</sup> The paper generally assumes that the GET is forward shifted to the purchaser. See Besley and Rosen (1999) and Poterba (1996) for research that supports the sales tax being forward shifted to the consumer.

lessen the extent of pyramiding – effectively the transactions remain taxable but the amount of tax built into the transaction is reduced. An example is that Hawaii enacted the capital goods excise tax in 1988 to reduce pyramiding of tax on certain goods used to generate income. Exemptions and lower rates do not apply to most services in Hawaii.

### Extent of Pyramiding

The broad GET base combined with limited exemptions raises the likelihood of relatively high tax pyramiding. A listing of sales tax revenues as a share of the economy for every state shows Hawaii is the only state where sales tax revenue as a percent of the economy is higher than the state sales tax rate (see Table 1). Collecting tax as a share of the economy that is higher than the tax rate provides anecdotal evidence of pyramiding on average in Hawaii.

**Table 1: State Sales Tax as Percent of Personal Income, FY2013**

| <b>United States</b> | <b>1.80%</b> |                |       |
|----------------------|--------------|----------------|-------|
| Hawaii               | 4.64%        | South Carolina | 1.87% |
| Washington           | 3.34%        | California     | 1.83% |
| Nevada               | 3.32%        | Iowa           | 1.82% |
| North Dakota         | 3.30%        | Ohio           | 1.82% |
| Mississippi          | 3.15%        | Rhode Island   | 1.78% |
| Indiana              | 2.68%        | Wisconsin      | 1.78% |
| Arizona              | 2.64%        | Utah           | 1.77% |
| New Mexico           | 2.62%        | Connecticut    | 1.77% |
| Arkansas             | 2.61%        | New Jersey     | 1.72% |
| Tennessee            | 2.58%        | Pennsylvania   | 1.57% |
| Florida              | 2.56%        | Oklahoma       | 1.56% |
| Wyoming              | 2.28%        | Louisiana      | 1.48% |
| Idaho                | 2.27%        | North Carolina | 1.47% |
| Kansas               | 2.25%        | Georgia        | 1.40% |
| Texas                | 2.25%        | Massachusetts  | 1.35% |
| South Dakota         | 2.19%        | Illinois       | 1.35% |
| Michigan             | 2.18%        | Alabama        | 1.32% |
| Maine                | 1.97%        | Maryland       | 1.29% |
| Minnesota            | 1.95%        | Missouri       | 1.28% |
| West Virginia        | 1.91%        | Vermont        | 1.22% |
| Kentucky             | 1.90%        | New York       | 1.13% |
| Nebraska             | 1.89%        | Colorado       | 0.98% |

Relatively little research has focused on the extent of sales tax pyramiding, though insight is provided by several studies. The studies generally examine the average propensity for pyramiding across broad sets of goods and services and find pyramiding to be a smaller concern than is sometimes



asserted. However, tax pyramiding is very product and case specific, so the extent will vary depending on the number of steps in the production chain, the states where these transactions occur, the tax rate applied to each transaction, the legal structures used by businesses and so forth. The bottom line is that pyramiding can be a large problem for certain types of transactions, regardless of the average extent. The remainder of this section discusses general evidence on pyramiding and the following section provides an example of GET pyramiding on hotels owned by REITs.

The two earliest Hawaii Tax Review Commissions examined GET pyramiding and generally found modest levels, but the studies also recognized that it is a larger problem for services and for rental property. Billings' analysis for the 1984 Tax Commission found moderate pyramiding, but services were subject to more pyramiding than goods. As a result, the Commission recommended a policy change to reduce a specific case of pyramiding. It recommended, "To remove the inequitable taxation of certain inter-affiliate transactions, the Commission recommends that receipts from the sales of goods or services by a parent company doing business in Hawaii to its wholly owned subsidiaries not be taxable if the parent to whom the receipts accrue is not in the business of providing these goods and services to anyone other than its subsidiaries but its subsidiary firms."<sup>10</sup> The recommendation was focused on addressing one of the most extreme examples of discrimination (or non-neutralities) by the GET, when tax treatment differs between firms based on whether they choose to organize their internal operations in multiple companies versus in a single integrated company. The Commission proposed collection of the GET on firms' sales to affiliates when the firms also sell to non-affiliated customers, which suggested that arm's length transactions were occurring.

Leung and Bowen (1988), who also worked for the second Hawaii Tax Review Commission, used an input-output model to address the extent of GET pyramiding.<sup>11</sup> They conclude that the 4 percent GET pyramids to a 5.4 percent tax on average tourist expenditures. But, they also point out that services pyramid more than goods, and rental property will be among the services subject to the greatest pyramiding. They note that the structure provides particular incentives for firms to vertically integrate.

A study conducted for the State of Washington Tax Study Commission (2002) concluded that pyramiding of the Washington Business and Occupations (B&O) Tax, also a gross receipts tax is much more extensive than was found in research focused on Hawaii. The B&O tax pyramids an average of 2.5 times, but the extent of pyramiding varies widely by industry. The B&O tax pyramids more than twice on lodging, such as hotels.

### **GET Pyramiding with Taxes on Hotels**

As described in the previous section, the degree of pyramiding is very specific to ownership arrangements and the types of goods and services being delivered, so the averages are not indicative of

---

<sup>10</sup> Hawaii Tax Review Commission (1984), Recommendation No. 11, p. 9.

<sup>11</sup> Leung and Bowen follow the approach developed by Bahl and Shellhammer (1969) to estimate sales tax pyramiding in West Virginia.

how pyramiding affects specific companies, services, and transactions. Hotel services that are delivered by corporate siblings of a hotel REIT are a specific example where pyramiding can be significant. Federal REIT laws require that the owners and the tenants of the hotel be separated, which potentially sets hotels up for GET taxation at multiple levels.<sup>12</sup> A related example is that hotels built on leased land may be subject to pyramiding because the lease payments are taxable as well as the sale to tourists.

Consider the following example, which focuses specifically on REITs:

A REIT must place its hotels into a separate company that owns the hotel (LANDLORD in Figure 2).<sup>13</sup> The landlord must lease the hotel to a separate company that owns the hotel operations (LESSEE) the hotel. LESSEE must contract with a third party management company (MANAGE) to operate the hotel on behalf of the LESSEE.<sup>14</sup> Suppose the hotel sells services (room rental, retail in gift shops, food services, parking, etc.) and receives \$100 million. Hawaii imposes the GET on room rentals and other goods and services provided by hotels, so MANAGE pays \$4.0 million in GET (\$100 million times 4%).<sup>15</sup> LESSEE pays LANDLORD \$60 million as rental for the hotel after paying some expenses and a management fee. The rent is also subject to the GET even though LANDLORD and LESSEE are owned by the same parent corporation. LANDLORD pays \$2.4 million in GET (\$60 million times 4%). In addition, a series of vendors (VENDORS) sell goods and services to MANAGE that are subject to the GET. These firms provide food products, cleaning products, transportation services, cleaning services, and other inputs and pay GET at either a 0.5% or 4% rate, depending on the specific transaction. Vendors would pay \$0.3 million in GET if \$15 million in goods and services are purchased at an average GET rate of 2%.<sup>16</sup> Combined, the GET would be \$6.7 million on final tourist sales of \$100 million, resulting in an effective GET rate of 6.7 percent. Thus, the total GET is the 4 percent legislated rate plus 2.7 percent of pyramided tax. The effective rate is 7.0 percent when compared with the \$96 million net of tax expenditures made by the tourists (\$100 million total expenditures - \$4.0 GET paid by LESSEE). Thus, the effective GET rate is raised by about 75 percent because of the pyramiding. The Transient Accommodations Tax rate is 9.25 percent, evidencing that a combined 16.25 percent rate is levied on hotel rooms in Hawaii.

The pyramided tax would be even higher in Honolulu, where an additional 0.5 percent rate is imposed for light rail. Assume the same example as above, with MANAGE collecting \$100 million in revenues, \$60 million transferred to the LANDLORD, and purchases \$15 million in goods and services

---

<sup>12</sup> IRS rules are very demanding and require REITs to distribute 90 percent of their annual taxable income. Further, the rules do not permit the owner of the hotel to book the revenues. Thus, separate entities are required for hotel ownership and operations ownership and these required relationships are important causes of GET pyramiding. This problem of GET pyramiding for hotels was solved through an exemption in the GET when the landlord company purchases management services from a subsidiary that does not deliver services to other buyers, but not in cases where the two entities are siblings in the corporate tax structure.

<sup>13</sup> The example illustrates the places where GET arises, but is not intended to account for all of the intricacies of the corporate relationships required under the REIT rules.

<sup>14</sup> Marriott, Hyatt, Starwood, and Hilton are examples of third party management companies.

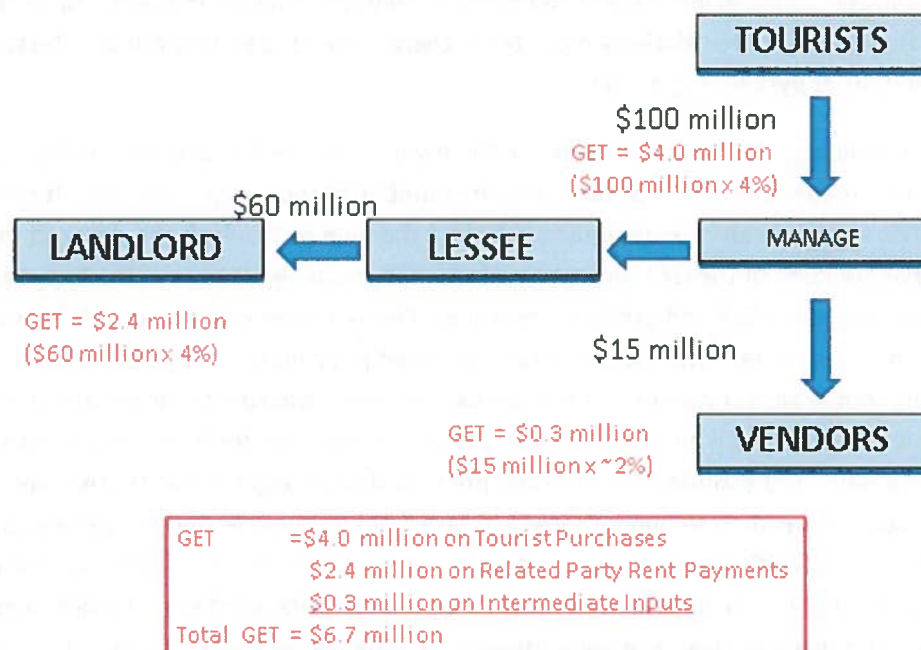
<sup>15</sup> The GET is legally a liability of the hotel, not the guests, even though the tax is frequently stated on the bill.

<sup>16</sup> The vendors may purchase intermediate inputs from other firms that also are subject to the GET, so at least one other level of pyramiding may occur.

from VENDORS. The pyramided GET effective rate on net of tax purchases would be 7.9 percent.<sup>17</sup> Thus, the combined GET and Transient Accommodations Tax would be 17.15 percent in Honolulu.

Based on a special exemption in GET statutes, the hotel enterprise could reduce much of the pyramiding by having the parent company own the hotel and have it operated through a single purpose subsidiary that only manages hotels for the parent. However, this arrangement is not permissible under REIT rules.

**Figure 2: Hotel Pyramiding Example**



### Problems with Tax Pyramiding

Economists widely agree that the best taxes are ones that do not change the behavior of businesses and people from what they would otherwise do. Tax pyramiding harms the economy because it alters behavior as the tax implicit in items depends on factors such as the organizational structure of the businesses and the number of taxed steps in the supply chain. In other words, the effective tax rate differs across transactions and these differing rates change how people and businesses behave. The differential tax included in prices is capricious (in the sense that it depends on things such as the number of stages in the production process) and is not linked to any public policy purpose.

<sup>17</sup> LESSEE would pay \$4.5 million in GET, LANDLORD would pay \$2.7 million, and \$0.3 million would be paid by VENDORS, resulting in \$7.5 million in taxes on \$95.5 million net of tax payments by tourists.

Three types of decisions can be altered by the differences in effective tax rates because of pyramiding: what people including tourists buy, how businesses are structured and operate, and the degree to which firms locate and produce in Hawaii. These distortions harm the economy and make people worse off.

### Tourist Responses

Buyers respond to taxes by purchasing relatively less of items that include more tax, whether the tax is hidden in higher prices or separately articulated to the buyer. For example, tourists will be less likely to purchase items where more pyramiding has taken place because the effective tax rate is higher. Tourists may not realize that the tax has pyramided, but will buy less because of the higher prices (assuming the tax is fully forward shifted in higher prices to consumers as was discussed above). So, tourists may choose to stay in less expensive hotels, to stay fewer nights in Hawaii, or to spend less in Hawaii since these items have relatively more tax in them. Tourist spending will be affected most where the greatest extent of pyramiding occurs.

The pyramiding calculations provided in the example above focused only on the tax revenues associated with a single hotel and assumed that the number of room nights was unaffected by pyramiding. The example can be extended to estimate the degree to which the demand for hotel rooms is reduced by pyramiding of the GET, how the reduction in room nights affects total spending in Hawaii, and the effects on overall GET and other tax revenues. The key issue is the responsiveness of rooms purchased to increases in tax inclusive room rates (termed price elasticity by economists). The price elasticity is not known with certainty, but the discussion below brackets the likely effect. Two studies have used Hawaii's experience and data to estimate price elasticities for hotel rooms. Fuleky, Bonham, and Zhou (2013) say, "The estimated hotel room price elasticity suggests that tourists are more responsive to room rates than to fluctuations in airfare." They conclude that the price elasticity for hotel room demand is -1.2, which means a 1 percent room price increase lowers rooms purchased by tourists by 1.2 percent. Bonham, Fujii, Im and Mak (1992) used Hawaii data and found a much lower demand responsiveness to price increases. However, their study is based on a much earlier time period. In a broader national study, Green and Lomanno (2012) estimate elasticities between -.1 and -.5, depending on the quality of hotel, with the highest elasticities for more luxurious hotels.

The price elasticities found in each study evidence that the pyramided tax reduces the number of rooms sold, so affected hotels will generate less revenue and the private sector and the number of jobs in Hawaii are harmed. The impact on rooms sold varies with the different elasticities, but in all cases fewer hotel rooms will be sold because of the pyramided tax, and the Hawaii economy loses the jobs and economic activity associated with the spending. The range within which room rentals is affected can be suggested using the price elasticity estimates. For example, a 1000 room hotel charging \$200 per night can expect to lose over 2000 room nights per year, even with the relatively low price elasticity of only -.25.<sup>18</sup> The hotel loses about 10,000 rooms per year if the recent study of Hawaii's experience by Fuleky, Bonham and Zhou provides the best measure of price elasticity. The bottom line is that

---

<sup>18</sup> The estimated effects are reduced to the extent that potential tourists shift to other, cheaper Hawaii hotels rather than reduce their stay in Hawaii or travel to another location.

significant room nights are lost using any reasonable price elasticity. The hotel loses about \$2.0 million in room rentals with the -1.2 elasticity, and Hawaii loses other economic activity arising from additional tourist nights on the islands. The expenditure loss to Hawaii doubles assuming tourists spend as much per day on meals, shopping, entertainment, and so forth as on hotel rooms.<sup>19</sup>

Imposition of the GET at both the lessee and landlord levels raises additional GET revenues compared with only levying the tax at the management level, but the total increase depends on how much room rentals are reduced. The overall GET revenue gain from pyramiding is lower than might be expected because of fewer room nights (on which less GET is obtained from the hotel operations entity and from the hotel owning company and less Tourist Accommodations Tax is collected on room nights) and because tourists spend less throughout Hawaii (so less GET is collected from these expenditures as well). Overall, the GET and Tourist Accommodations Tax increase between \$100,000 and \$500,000 less than anticipated from the pyramiding because of fewer room nights, with the specific effects depending on the price elasticity. Personal income taxes for workers and corporate income taxes are also reduced by the reduction in room nights and lower spending in Hawaii.

Total expenditures in Hawaii rise if the additional GET because of pyramiding (less the other tax reductions described in the previous paragraph) exceeds the hotel and other tourist expenditures lost because of fewer room nights. The GET gain approximately equals the hotel and non-hotel expenditure loss if the price elasticity of demand is -0.6. The combined Hawaii public and private sector gains some net revenue if the price elasticity is lower than -0.6, because the total net increase in GET exceeds the lost hotel revenues, since relatively few hotel room nights are lost if the elasticity is this low. The combined revenue actually decreases if the elasticity is near the estimated -1.2, since many room nights are lost. The combined revenue loss to Hawaii would be smaller to the extent that people shift to less expensive hotels in Hawaii rather than reduce room nights.

### Business Responses

Businesses are treated differently under the GET depending on their structures and practices. Firms pay lower taxes when they vertically integrate to bring steps in the production chain within the integrated firm versus when they produce the same services by operating multiple businesses or purchasing inputs from unrelated suppliers. This occurs because the tax is imposed on externally purchased items but not internally produced inputs. The result is distortion of tax neutrality, which exists when taxes do not alter business behavior.

Firms respond to the lack of neutrality by vertically integrating when the tax savings exceed any additional costs of vertical integration.<sup>20</sup> The tax is imposed as transactions occur, and firms can avoid this tax by purchasing their supplier or producing their own inputs so no external transaction takes place. Vertical integration can be good business practice, but it should take place when it is the best way

---

<sup>19</sup> Lodging expenditures comprise 41.6 percent of total expenditures by air and cruise visitors according to the "2013 Annual Visitor Research Report," Hawaii Tourism Authority, p. 113, so a doubling of the hotel expenditure is a modest assumption.

<sup>20</sup> See Fox and Murray (1988).

of doing business, and not because it is a tax avoidance mechanism. Firms would vertically integrate without the tax considerations if it was the best business practice. The overall cost of production for the Hawaii and U.S. economies is raised if vertical integration happens only to avoid payment of tax on the transaction (the cost to the economy is the increase in costs to produce net of tax).

A related effect is that pyramiding makes it more difficult for small firms to startup or succeed.<sup>21</sup> Smaller firms can be expected to have less capacity to vertically integrate so they are likely to pay higher taxes than a larger, vertically integrated firm producing the same service. Further, larger firms that may otherwise outsource to small firms are discouraged by the pyramiding, thereby lowering demand for small firms. Both effects disadvantage small firms relative to large firms.

### Effects on Business Location and Production

Imposition of the GET on intermediate transactions raises the costs of doing business in Hawaii. Higher production costs can discourage firms from producing in Hawaii, whether for international, mainland or Hawaii markets. The result is that high GET on businesses hurts the health of the Hawaii economy. For example, Phillips et al (2014) estimate that businesses pay 37 percent of the GET in taxes on intermediate transactions (excluding the tax on sales to final consumers).<sup>22</sup> This suggests that about 1.75 percent of the economy is paid in GET on business purchases, which is a significant increase in costs of doing business. By comparison, Hawaii's corporate income tax collected \$123.7 million in 2013, or less than 0.2 percent of personal income. Thus, the GET is much more important as a tax cost to business than is the corporate income tax. The GET implicit in sales is also much higher than in other states.<sup>23</sup> This high cost on production in Hawaii can be reduced by lowering the extent of pyramiding.

Also, Fox (1992) observed that pyramiding of the tax provides businesses with the incentive to hide transactions, such as those that could arise between affiliated businesses or with leases and subleases. An example is given in a recent HawaiiBusiness article discussing Act 05 of 2011,<sup>24</sup> which argues that unlicensed contractors often work for cash and do not pay the GET, while licensed contractors seek to compete after paying the tax. The result is a tax system that is more difficult to administer, less neutral across businesses, and penalizes firms that become part of the formal market.

### **GET Exemptions**

Good tax policy in Hawaii would be to eliminate other cases where non-transparent pyramiding of GET is significant. GET imposed on hotels owned by REIT's and hotels built on rented land are clear

---

<sup>21</sup> See Marcie Kagawa, "Hawaii's Tax Pyramid Plan Crippling Small Businesses," HawaiiBusiness April 2012.

<sup>22</sup> Phillips et al (2014) estimate that businesses paid \$1.1 billion of GET in 2013 on business to business transactions. The Census Bureau reports total GET collections of \$2.944 billion. Combined these indicate that business paid 37.4 percent of the GET on business to business transactions and the remainder is paid on business to consumer transactions (including sales to tourists). Ring (1999) found that tourists or businesses pay 72 percent of Hawaii's GET, with residents paying only 28 percent. In a working paper, A more recent study by Birkeland and Ring (2014) estimates that the share of the GET paid by tourists and businesses had risen to 81 percent in 2012.

<sup>23</sup> The *share* of GET paid by business is not high on national standards, but only because consumers pay tax on so much of their final purchases and not because businesses pay little on their purchases.

<sup>24</sup> See Footnote 21.

examples of pyramiding and much higher total explicit and implicit taxes than is apparent in the legislated rates. Strong precedents exist for reducing pyramiding in cases where it would otherwise impact or disadvantage sound business practices. In other situations, this has been accomplished through a series of appropriately structured exemptions, though in many cases the exemptions reduce the rate from 4.0 percent to 0.5 percent rather than to a zero percent rate. For example, in 1998 Hawaii enacted an exemption for subleases (Section 237-16.5) that effectively lowered the rate from 4.0 percent to 0.5 percent on subleases. Among others, exemptions are also granted for:

- Services provided from one related entity to another (Section 237-23.5)
- Amounts received as salaries and wages (Section 237-24)
- Management fees for condominium managers (Section 237-24.3)
- Amounts received by an operator of a hotel from the owner of the hotel, which are disbursed by the operator for employee wages, salaries, payroll taxes, benefits, etc. (Section 237-24.7)

## References

- Bahl, Roy and Kenneth Shellhammer. 1969. Evaluating the State Business Tax Structure: An Application of Input-Output Analysis," *National Tax Journal*, 22(2): 203-216.
- Besley, Timothy J. and Harvey S. Rosen. 1999. "Sales Taxes and Prices: An Empirical Analysis," *National Tax Journal* 52(2): 157-178.
- Birkeland, Kathryn and Raymond Ring. 2014. "Consumers' Share and Producers' Share of the General Sales Tax, " working paper presented at the National Tax Association Annual Meetings, November.
- Bonham, Carl, Edwin Fujii, Eric Im, and James Mak. 1992. "The Impact of The Hotel Room Tax: An Interrupted Time Series Analysis," *National Tax Journal* 45(4): 433-41.
- Bruce, Donald, William Fox and Matthew Murray. 2003. "To Tax or Not to Tax: the Case of Electronic Commerce" *Contemporary Economic Policy*, 23(1): 25-40.
- Chamberlain, Patrick and Andrew Fleenor. 2006. "Tax Pyramiding: The Economic Consequences of Gross Receipts Taxes," The Tax Foundation, Special Report No. 147.
- Cline, Robert, Thomas Neubig and Andrew Phillips. 2013. "What's Wrong with Taxing Business Services," Council on State Taxation, April 4.
- Fox, William F. and Matthew Murray. 1988. "Economic Aspects of Taxing Services," *National Tax Journal*, 41(1):19-36.
- Fox, William F. 1992. "Excise Taxes," in *The Price of Paradise: Lucky we Live Hawaii?* edited by Randy Roth, Mutual Publishing: Honolulu.
- Fox, William F. 2002. "Should the Hawaii General Excise Tax Look Like Other States' Sales Taxes," Report prepared for the 2002 State of Hawaii Tax Review Commission, October 15.
- Fox, William F. 2006. "Hawaii's General Excise Tax: Should the Base be Changed?" Report prepared for the 2005-2007 State of Hawaii Tax Review Commission, October 4.
- Fox, William F. 2012. "Selected Issues with the Hawaii General Excise Tax," Report prepared for the 2010-2012 State of Hawaii Tax Review Commission, July 22.
- Fujii, Edwin, Mohammed Khaled, and James Mak. (1985). "The Exportability of Hotel Occupancy and Other Taxes," *National Tax Journal*, 38(2) June, 169-178.
- Fuleky, Peter, Carl S. Bonham, and Qianxue Zhou. 2013. "Estimating Demand Elasticities in Non-Stationary Panels: The Case of Hawai'i Tourism," UHERO Working Paper No. 2013-2R, August 15.
- Green, Cindy Estis and Mark V. Lomanno. 2012. "Distribution Channel Analysis: A guide for Hotels," HSMAI Foundation.



Hawaii Tax Review Commission. 1984. "Report of the First Tax Review Commission to the Thirteenth Legislature State of Hawaii, December 17.

Leung, Pingsun and Richard Bowen. 1988. "Using Input-Output Analysis to Estimate Tax Pyramiding and Tax Exporting in Hawaii," *Annals of Regional Science* 22(1):49-62.

Phillips, Andrew et al. 2014, "Total State and Local Business Taxes: State by State Estimates for Fiscal Year 2013," Council on State Governments, August.

Poterba, James. 1996. "Retail Price Reactions to Changes in State and Local Sales Taxes," *National Tax Journal*, 49(2): 165-76.

Ring, Raymond. 1999. "Consumers' Share and Producers' Share of the General Sales Tax," *National Tax Journal*, 52(1): 79-90.

Washington State Tax Review Commission. 2002. "Tax Alternatives for Washington State: A Report to the Legislature," November.

