

A Bill for an Act Relating to Taxation.

Be It Enacted by the Legislature of the State of Hawaii:

SECTION 1. The legislature finds that economic activity in Hawaii is at one of its lowest levels. In order to encourage economic activity, the legislature believes that it must address certain structural problems existing in the Hawaii economy which add to the high cost of living in Hawaii and the overall cost of doing business. One of the most pervasive structural problems is the pyramiding of the general excise tax on lease activity. Under existing law, the general excise tax is imposed on the leasing and subleasing of the same parcel of real property. Each level of leasing pays the four per cent general excise tax on its gross proceeds from leasing. In a leasing situation with four tiers—a lessor to a sublessor to a sublessor to a lessee—the final lessee will pay the equivalent of a general excise tax of twelve per cent—four per cent on the lessor and each sublessor.

The purpose of this Act is to alleviate the effects of the pyramiding of the general excise tax on lease and sublease transactions.

The legislature finds that mitigating the pyramiding aspect of leasing will benefit the Hawaii economy and the people of Hawaii as more money will be available to business to expand or hire additional employees to provide better service, and the overall cost of living in Hawaii will be reduced. The legislature recognizes that mitigating pyramiding on leasing activities may affect state revenues. However, an incremental reduction in revenues over a seven-year period, even with the present reduced state revenues, will be beneficial to the State as tax revenues generated by business and taxpayers from expenditures of money which would otherwise have been paid to the State under the existing pyramiding tax structure will more than offset lost tax revenue under this Act.

The legislature further recognizes that the pyramiding tax issue contains many knotty problems raised in prior attempts at legislation in this area. This Act addresses those issues in a way that balances the interest of the State in taxing economic activity and the interest of the business community by removing some of the multiple and burdensome levels of taxation.

The Act, once fully phased in, allows a sublessor to reduce the amount of gross proceeds or gross income received under a written lease of real property by seven-eighths of the amount the sublessor pays to its lessor for the same real property in determining the gross proceeds or gross income subject to the general excise tax. The fraction of seven-eighths was determined by comparing the retail rate of tax (4.0 per cent) with the rate of tax normally applicable to intermediate stage transactions (0.5 per cent or one-eighth of the 4.0 per cent). It reflects the philosophy expressed in the recent Tax Review Commission report that intermediate stage transactions should be subject to a uniform rate of tax.

Under this Act, for example if under a written lease, lessor A leases real property X to lessee B for \$1,000 a year and lessee B subleases the same real property X to C for \$2,500 a year, B would be entitled to a \$1,000 deduction times seven-eighths, or \$875, from the \$2,500 amount received under the written sublease. The lessor would pay four per cent of \$1,000, or \$40, and the lessee would pay four per cent of \$2,500 minus \$875, or \$65 in tax. The total tax payable by both parties ($\$40 + \$65 = \$105$) is the same as if the intermediate stage rent were taxed at one-half per cent (0.5 per cent of \$1,000 = \$5) and the retail stage rent were taxed at four

per cent (4 per cent of \$2,500 = \$100). In other words, unlike current law, \$875 would not be subject to the four per cent general excise tax twice.

The legislature notes that when a lessee leases real property, the person in many instances compensates the lessor for the actual real property or space which the person is using and for common areas such as stairs, walls, parking spaces, real property taxes (which may be paid directly to the county by the lessee or sublessee), general excise taxes, and certain affixed personalty. All compensation paid to or for the benefit of a lessor or sublessor that is consideration for the lease should be considered gross proceeds or gross income paid under the lease.

This Act recognizes that in many instances the lessee may only sublease a portion of the total area of real property which the lessee leased from its lessor. In these cases, the Act requires that the lessee's deduction be based upon the amount actually paid by the lessee to its lessor for the subleased portion of the total real property leased by the lessee.

The sublessor's method for allocating the rent to the subleased portion shall be reasonable under the circumstances, taking into consideration the size, quality, and location of the subleased premises. In no case shall the amount of the deductions claimed by the lessee exceed the total amount paid to its lessor for the use of the property. For example, if, under a written lease, A leases real property X to B for \$1,000, which in turn subleases fifty per cent of X to C for \$2,500, assuming there are no significant differences between the portion of X subleased by B and the portion not being subleased which would significantly affect the value of the respective portions of X, a deduction based upon an allocation of the percentage of the area of X being subleased would be reasonable. In this case, B's deduction would be limited to fifty per cent of the \$1,000 amount B paid to A for the lease of all of X. B's deduction would be \$500 multiplied by seven-eighths or \$437.50.

If, however, differences in the size, location, or quality of the areas within the leased real property significantly affect the relative values of the real property or space, those factors shall be considered in determining a reasonable basis for allocation. For example, assume the same facts in the example above except that real property X constitutes ground floor retail real property or space (which has a rental value of \$800) and upper floor office real property or space (which has a rental value of \$200) equal in size to the ground floor retail real property or space under lease, and that B subleases only the upper floor real property or space to C for \$2,500. B's deduction under this Act against the \$2,500 gross income would be limited to \$200 multiplied by seven-eighths, or \$175, the portion of the \$1,000 a year paid by B to A allocable to the upper floor real property or space. A deduction based upon the percentage of the real property or space leased would not be a reasonable allocation method under these circumstances.

In recognition of the complexities anticipated in implementing the provisions of this Act, rules issued by the department of taxation shall provide the necessary guidance in implementing the intent of the legislature as applied to the various factual situations affected.

SECTION 2. Chapter 237, Hawaii Revised Statutes, is amended by adding a new section to be appropriately designated and to read as follows:

“§237- Tax on written real property leases; deduction allowed. (a)

This section relates to the leasing of real property by a lessor to a lessee. There is hereby levied, and shall be assessed and collected annually, a privilege tax against persons engaging or continuing within the State in the business of leasing real property to another, equal to four per cent of the gross proceeds or gross income received or derived from the leasing; provided that where real property is subleased by a lessee to a sublessee, the lessee, as provided in this section, shall be allowed a

deduction from the amount of gross proceeds or gross income received from its sublease of the real property. The deduction shall be in the amount allowed under this section.

All deductions under this section and the name and general excise tax number of the lessee's lessor shall be reported on the general excise tax return. Any deduction allowed under this section shall only be allowed with respect to leases and subleases in writing and relating to the same real property.

(b) The lessee shall obtain from its lessor a certificate, in the form as the department shall prescribe, certifying that the lessor is subject to tax under this chapter on the gross proceeds or gross income received from the lessee. The absence of the certificate in itself shall give rise to the presumption that the lessee is not allowed the deduction under this section.

(c) If various real property or space leased to the lessee have different rental values, then the total monetary gross proceeds or gross income paid to a lessor for all real property or space shall first be allocated to the fair rental value for each real property or space. If the lessee leases less than one hundred per cent of real property or space that was leased from the lessor to a sublessee, then the total monetary gross proceeds or gross income paid by the lessee for that real property or space to its lessor shall be allocated. The percentage of real property or space subleased shall be multiplied by the monetary gross proceeds or gross income paid for the real property or space by the lessee to its lessor. The product of the preceding multiplication shall be deducted from the monetary gross proceeds or gross income received for real property or space by the lessee.

Once the allocations are made, the appropriate deduction under subsection (g) shall be made.

(d) The lessor shall make allocations under this section at the time the sublease is entered into and the allocations shall not be changed during the term of the sublease. There shall be a reasonable basis for the allocations, taking into consideration the size, quality, and location of the real property or space subleased. In no event shall the total amount allocated to all subleases exceed the total monetary gross proceeds paid by the lessee to its lessor. The director may redetermine the amount of the deduction under this section if the director finds that the basis for allocation is not reasonable or that redetermination is necessary to prevent the avoidance of taxes.

(e) As used in this section:

"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 lease, and includes a sublessee.

"Lessor" means one who conveys real property by lease, and includes a sublessor.

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

"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. Sublease includes the written extension or renegotiation of a sublease and any holdover tenancy under the written sublease.

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

"Sublessor" means one who conveys real property by sublease.

(f) This section shall not cause the tax upon a lessor, with respect to any item of the lessor's gross proceeds or gross income, to exceed four per cent.

(g) After allocation under subsection (c), if necessary, the deduction under this section shall be allowed from the gross proceeds or gross income of the lessee received from its sublease in an amount calculated by multiplying the gross proceeds or gross income paid by the lessee to its lessor for the lease of the real property by the following amount:

- (1) In calendar year 1998, .125;
- (2) In calendar year 1999, .25;
- (3) In calendar year 2000, .375;
- (4) In calendar year 2001, .50;
- (5) In calendar year 2002, .625;
- (6) In calendar year 2003, .75; and
- (7) In calendar year 2004, and thereafter, .875.

The amount calculated under paragraphs (1) to (7) shall be deducted by the lessee from the lessee's total reported gross proceeds or gross income. The deduction allowed by this subsection may be taken by the fiscal and calendar year lessees."

SECTION 3. Section 237-13, Hawaii Revised Statutes, is amended to read as follows:

"§237-13 Imposition of tax. There is hereby levied and shall be assessed and collected annually privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross income, whichever is specified, as follows:

- (1) Tax on manufacturers.
 - (A) Upon every person engaging or continuing within the State in the business of manufacturing, including compounding, canning, preserving, packing, printing, publishing, milling, processing, refining, or preparing for sale, profit, or commercial use, either directly or through the activity of others, in whole or in part, any article or articles, substance or substances, commodity or commodities, the amount of the tax to be equal to the value of the articles, substances, or commodities, manufactured, compounded, canned, preserved, packed, printed, milled, processed, refined, or prepared, for sale, as shown by the gross proceeds derived from the sale thereof by the manufacturer or person compounding, preparing, or printing them, multiplied by one-half of one per cent.
 - (B) The measure of the tax on manufacturers is the value of the entire product for sale, regardless of the place of sale or the fact that deliveries may be made to points outside the State.
 - (C) If any person liable for the tax on manufacturers ships or transports the person's product, or any part thereof, out of the State, whether in a finished or unfinished condition, or sells the same for delivery outside of the State (for example, consigned to a mainland purchaser via common carrier f.o.b. Honolulu), the value of the products in the condition or form in which they exist immediately before entering interstate or foreign commerce, determined as hereinafter provided, shall be the basis for the assessment of the tax imposed by this paragraph. This tax shall be due and payable as of the date of entry of the products into interstate or foreign commerce, whether the products are then sold or not. The department of taxation shall determine the basis for assessment, as provided by this paragraph, as follows:

- (i) If the products at the time of their entry into interstate or foreign commerce already have been sold, the gross proceeds of sale, less the transportation expenses, if any, incurred in realizing the gross proceeds for transportation from the time of entry of the products into interstate or foreign commerce, including insurance and storage in transit, shall be the measure of the value of the products.
 - (ii) If the products have not been sold at the time of their entry into interstate or foreign commerce, and in cases governed by clause (i) in which the products are sold under circumstances such that the gross proceeds of sale are not indicative of the true value of the products, the value of the products constituting the basis for assessment shall correspond as nearly as possible to the gross proceeds of sales for delivery outside the State, adjusted as provided in clause (i), or if sufficient data are not available, sales in the State, of similar products of like quality and character and in similar quantities, made by the taxpayer (unless not indicative of the true value) or by others. Sales outside the State, adjusted as provided in clause (i), may be considered when they constitute the best available data. The department shall prescribe uniform and equitable rules for ascertaining [such] the values.
 - (iii) At the election of the taxpayer and with the approval of the department, the taxpayer may make the taxpayer's returns under clause (i) even though the products have not been sold at the time of their entry into interstate or foreign commerce.
 - (iv) In all cases in which products leave the State in an unfinished condition, the basis for assessment shall be adjusted so as to deduct [such] the portion of the value as is attributable to the finishing of the goods outside the State.
- (2) Tax on business of selling tangible personal property; producing.
- (A) Upon every person engaging or continuing in the business of selling any tangible personal property whatsoever (not including, however, bonds or other evidence of indebtedness, or stocks), there is likewise hereby levied, and shall be assessed and collected, a tax equivalent to four per cent of the gross proceeds of sales of the business; provided that insofar as certain retailing is taxed by section 237-16, the tax shall be that levied by section 237-16, and in the case of a wholesaler, the tax shall be equal to one-half of one per cent of the gross proceeds of sales of the business. Upon every person engaging or continuing within this State in the business of a producer, the tax shall be equal to one-half of one per cent of the gross proceeds of sales of the business, or the value of the products, for sale, if sold for delivery outside the State or shipped or transported out of the State, and the value of the products shall be determined in the same manner as the value of manufactured products covered in the cases under paragraph (1)(C).
 - (B) Gross proceeds of sales of tangible property in interstate and foreign commerce shall constitute a part of the measure of the tax imposed on persons in the business of selling tangible personal property, to the extent, under the conditions, and in accordance with the provisions of the Constitution of the United States and

the Acts of the Congress of the United States which may be now in force or may be hereafter adopted, and whenever there occurs in the State an activity to which, under the Constitution and Acts of Congress, there may be attributed gross proceeds of sales, [such] the gross proceeds shall be so attributed.

- (C) No manufacturer or producer, engaged in such business in the State and selling the manufacturer's or producer's products for delivery outside of the State (for example, consigned to a mainland purchaser via common carrier f.o.b. Honolulu), shall be required to pay the tax imposed in this chapter for the privilege of so selling the products, and the value or gross proceeds of sales of the products shall be included only in determining the measure of the tax imposed upon the manufacturer or producer [as such].
 - (D) When a manufacturer or producer, engaged in such business in the State, also is engaged in selling the manufacturer's or producer's products in the State at wholesale, retail, or in any other manner, the tax for the privilege of engaging in the business of selling the products in the State shall apply to the manufacturer or producer as well as the tax for the privilege of manufacturing or producing in the State, and the manufacturer or producer shall make the returns of the gross proceeds of the wholesale, retail, or other sales required for the privilege of selling in the State, as well as making the returns of the value or gross proceeds of sales of the products required for the privilege of manufacturing or producing in the State. The manufacturer or producer shall pay the tax imposed in this chapter for the privilege of selling its products in the State, and the value or gross proceeds of sales of the products, thus subjected to tax, may be deducted insofar as duplicated as to the same products by the measure of the tax upon the manufacturer or producer for the privilege of manufacturing or producing in the State; except that no producer of agricultural products who sells the products to a purchaser who will process the products outside the State shall be required to pay the tax imposed in this chapter for the privilege of producing or selling those products.
 - (E) A taxpayer selling to a federal cost-plus contractor may make the election provided for by paragraph (3)(C), and in [any such] that case the tax shall be computed pursuant to the election, notwithstanding this paragraph or paragraph (1) to the contrary.
 - (F) The department, by rule, may provide that a seller may take from the purchaser of tangible personal property a certificate, in [such] a form as the department shall prescribe, certifying that the sale is a sale at wholesale. If the certificate is so provided for by rule of the department:
 - (i) Any purchaser who furnishes [such] a certificate shall be obligated to pay to the seller, upon demand, if the sale in fact is not at wholesale, the amount of the additional tax which by reason thereof is imposed upon the seller; and
 - (ii) The absence of [such] a certificate, unless the sales of the business are exclusively at wholesale, in itself shall give rise to the presumption that the sale is not at wholesale.
- (3) Tax upon contractors.
- (A) Upon every person engaging or continuing within the State in the business of contracting, the tax shall be equal to four per cent of

- the gross income of the business; provided that insofar as the business of contracting is taxed by section 237-16, which relates to certain retailing, the tax shall be that levied by section 237-16.
- (B) In computing the tax levied under this paragraph or section 237-16, there shall be deducted from the gross income of the taxpayer so much thereof as has been included in the measure of the tax levied under subparagraph (A) or section 237-16, on:
- (i) Another taxpayer who is a contractor, as defined in section 237-6;
 - (ii) A specialty contractor, duly licensed by the department of commerce and consumer affairs pursuant to section 444-9, in respect of the specialty contractor's business [as such]; or
 - (iii) A specialty contractor who is not licensed by the department of commerce and consumer affairs pursuant to section 444-9, but who performs contracting activities on federal military installations and nowhere else in this State,
- if the tax on the amount so deducted has been paid by the other person, or has been withheld by the taxpayer and shall be paid over by the taxpayer to the assessor at the time of filing the return, [such] the withholding being authorized by this paragraph; but any person claiming a deduction under this paragraph shall be required to show in the person's return the name of the person paying the tax on the amount deducted by the person or from whom the tax was withheld, and shall issue a receipt for any amount of tax withheld, which upon filing by the other taxpayer with the taxpayer's return, shall relieve the other taxpayer of liability for the amount of tax withheld.
- (C) In computing the tax levied under this paragraph against any federal cost-plus contractor, there shall be excluded from the gross income of the contractor so much thereof as fulfills the following requirements:
- (i) The gross income exempted shall constitute reimbursement of costs incurred for materials, plant, or equipment purchased from a taxpayer licensed under this chapter, not exceeding the gross proceeds of sale of the taxpayer on account of the transaction[.]; and
 - (ii) The taxpayer making the sale shall have certified to the department that the taxpayer is taxable with respect to the gross proceeds of the sale, and that the taxpayer elects to have the tax on [such] gross income computed the same as upon a sale to the state government.
- (D) A person who, as a business or as a part of a business in which the person is engaged, erects, constructs, or improves any building or structure, of any kind or description, or makes, constructs, or improves any road, street, sidewalk, sewer, or water system, or other improvements on land held by the person (whether held as a leasehold, fee simple, or otherwise), upon the sale or other disposition of the land or improvements, even if the work was not done pursuant to a contract, shall be liable to the same tax as if engaged in the business of contracting, unless the person shows that at the time the person was engaged in making the improvements it was, and for the period of at least one year after completion of the building, structure, or other improvements, it continued to be the person's purpose to hold and not sell or

otherwise dispose of the land or improvements. The tax in respect of the improvements shall be measured by the amount of the proceeds of the sale or other disposition that is attributable to the erection, construction, or improvement of such building or structure, or the making, constructing, or improving of the road, street, sidewalk, sewer, or water system, or other improvements. The measure of tax in respect of the improvements shall not exceed the amount which would have been taxable had the work been performed by another, subject as in other cases to the deductions allowed by subparagraph (B). Upon the election of the taxpayer, this paragraph may be applied notwithstanding the improvements were not made by the taxpayer, or were not made as a business or as a part of a business, or were made with the intention of holding the same. However, this paragraph shall not apply in respect of any proceeds that constitute or are in the nature of rent; all such gross income shall be taxable under paragraph (10)[.]; provided that insofar as the business of renting or leasing real property under a lease is taxed under section 237- , the tax shall be levied by section 237-.

- (4) Tax upon theaters, amusements, radio broadcasting stations, etc. Upon every person engaging or continuing within the State in the business of operating a theater, opera house, moving picture show, vaudeville, amusement park, dance hall, skating rink, radio broadcasting station, or any other place at which amusements are offered to the public, the tax shall be equal to four per cent of the gross income of the business.
- (5) Tax upon sales representatives, etc. Upon every person classified as a representative or purchasing agent under section 237-1, engaging or continuing within the State in the business of performing services for another, other than as an employee, there is likewise hereby levied and shall be assessed and collected a tax equal to four per cent of the commissions and other compensation attributable to the services so rendered by the person.
- (6) Tax on service business. Upon every person engaging or continuing within the State in any service business or calling not otherwise specifically taxed under this chapter, there is likewise hereby levied and shall be assessed and collected a tax equal to four per cent of the gross income of [any such] the business; provided that where any person engaging or continuing within the State in any service business or calling renders [such] those services upon the order of or at the request of another taxpayer who is engaged in the service business and who, in fact, acts as or acts in the nature of an intermediary between the person rendering [such] those services and the ultimate recipient of the benefits of [such] those services, so much of the gross income as is received by the person rendering the services shall be subjected to the tax at the rate of one-half of one per cent and all of the gross income received by the intermediary from the principal shall be subjected to a tax at the rate of four per cent; and provided that where any person is engaged in the business of selling interstate or foreign common carrier telecommunication services within and without the State, the tax shall be imposed on that portion of gross income received by [any such] a person from service which is originated or terminated in this State and is charged to a telephone number, customer, or account in this State notwithstanding any other state law (except for the exemption under section 237-23(a)(1)) to the contrary. If, under the Constitution and laws of the

United States, the entire gross income as determined under this paragraph of a business selling interstate or foreign common carrier telecommunication services cannot be included in the measure of the tax, [such] the gross income shall be apportioned as provided in section 237-21; provided that the apportionment factor and formula shall be the same for all persons providing [such] those services in the State.

- (7) Tax on insurance solicitors and agents. Upon every person engaged as a licensed solicitor, general agent, or subagent pursuant to chapter 431, there is hereby levied and shall be assessed and collected a tax equal to .15 per cent of the commissions due to [such] that activity.
- (8) Professions. Upon every person engaging or continuing within the State in the practice of a profession, including those expounding the religious doctrines of any church, there is likewise hereby levied and shall be assessed and collected a tax equal to four per cent of the gross income on the practice or exposition.
- (9) Tax on receipts of sugar benefit payments. Upon the amounts received from the United States government by any producer of sugar (or the producer's legal representative or heirs), as defined under and by virtue of the Sugar Act of 1948, as amended, or other Acts of the Congress of the United States relating thereto, there is hereby levied a tax of one-half of one per cent of the gross amount received, provided that the tax levied hereunder on any amount so received and actually disbursed to another by [such] a producer in the form of a benefit payment shall be paid by the person or persons to whom [such] the amount is actually disbursed, and the producer actually making [any such] a benefit payment to another shall be entitled to claim on the producer's return a deduction from the gross amount taxable hereunder in the sum of the amount so disbursed. The amounts taxed under this paragraph shall not be taxable under any other paragraph, subsection, or section of this chapter.
- (10) Tax on other business. Upon every person engaging or continuing within the State in any business, trade, activity, occupation, or calling not included in the preceding paragraphs or any other provisions of this chapter, there is likewise hereby levied and shall be assessed and collected, a tax equal to four per cent of the gross income thereof. In addition, the rate prescribed by this paragraph shall apply to a business taxable under one or more of the preceding paragraphs or other provisions of this chapter, as to any gross income thereof not taxed thereunder as gross income or gross proceeds of sales or by taxing an equivalent value of products, unless specifically exempted."

SECTION 4. Statutory material to be repealed is bracketed. New statutory material is underscored.¹

SECTION 5. This Act shall take effect on October 1, 1998.

(Approved July 3, 1997.)

Note

1. Edited pursuant to HRS §23G-16.5.