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MEMO TO: ALL CLIENTS
FROM: WILLIAM L. WONG, CPA, PFS
DATE: July 7, 2011
SUBJECT: ***KEY BUSINESS CHANGES IN GENERAL EXCISE TAXATION***

On June 9, 2011, Act 105, Sessions Laws of Hawaii 2011 was enacted where certain general excise and use tax exemptions were temporarily suspended, effective from July 1, 2011 until June 30, 2013. This means that certain amounts of gross income that were previously exempt, will now be subject to a tax of four percent (4%) and shall be **payable annually**. The Oahu County surcharge of one-half of one percent ($\frac{1}{2}$ %) shall not apply to this previously exempt gross income.

For most of our clients, there are three predominant or common exemptions taken on the general excise tax returns for which this new temporary suspension shall apply. They are the **Subcontractor Deduction**, the **Sublease Deduction** and the **Enterprise Zone** exemption.

The suspension shall NOT apply to gross income or gross proceeds from **binding written contracts entered into prior to July 1, 2011**, that do not permit the passing on of increased rates of taxes.

Finally, the Act **imposes new information reporting requirements on all exclusions or exemptions** taken on general excise tax returns, except for certain specific exempt transactions such as salaries and wages, alimony, gifts, bequests and inheritances, death benefits on life insurance, annuity contracts and endowments, health & accident insurance and workers compensation benefits, and personal injury awards. All other gross income, gross proceeds or transactions not subject to general excise or use taxes must be reported, even though they are still exempt from these taxes.

Subcontractor Deduction

The deduction for payments made to a licensed contractor by another contractor described under Hawaii Revised Statutes 237-13(3)(B) will no longer be allowed for the period July 1, 2011 to June 30, 2013. This means that if a general contractor passes on a 4% tax to his customer and the general contractor hires a subcontractor to perform part of the work, the general contractor cannot deduct payments made to the subcontractor, even if the subcontractor has charged the general contractor for his portion of the work at 4%. Therefore, the pyramiding (double taxation) of general excise taxes on contractors is back at least for two years ending June 30, 2013.

To ensure compliance with the requirements imposed by IRS Circular 230 (31 C.F.R part 10), you are hereby advised that any tax advice contained in this communication (including any attachments) was not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter(s) addressed herein.



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For binding written contracts entered into prior to July 1, 2011, there are three requirements in order for the contract NOT to apply with regard to the temporary suspension of the subcontractor deduction. First, the contract must not permit the general excise tax to be passed on to the customer. Second, the contract must be in writing. Third, the contract must be binding prior to July 1, 2011. For example, assume a general contractor signs a written contract to construct a building on June 30, 2011 and that it is a fixed fee contract which includes general excise taxes. If the general contractor hires a subcontractor on July 5, 2011, the general contractor may still claim subcontractor deductions on all payments made to the subcontractor, even though paid after June 30, 2011. Also, any change orders added after June 30, 2011 with this subcontractor will be eligible for the subcontractor deduction for the duration of the contract.

Sublease Deduction

The sublease deduction under Hawaii Revised Statutes 237-16.5 will no longer be allowed for the period July 1, 2011 to June 30, 2013. Prior to this Act, where a taxpayer leased property from a landlord and then subleased the same property to a tenant, the taxpayer could deduct from the taxable sublease income, a portion of the amount that the taxpayer pays to the landlord in computing its general excise tax liability, therefore avoiding the pyramiding (double tax) taxes on the same property.

For example, if a taxpayer pays \$1,000 per month plus 4.166% general excise taxes, or a total of \$1,041.66, to a landlord and then subleases the same property to a sublessee for \$1,100 per month (a \$100 sandwiched profit to the taxpayer) plus 4.166% general excise taxes, or a total of \$1,145.83, the Hawaii Department of Taxation would collect a total of \$87.49 on the property. In other words, on the same \$1,000 rental, the general excise tax liability would be \$83.32 plus \$4.17 on the additional \$100.00 sandwiched profit. Although the taxpayer only made a \$100.00 plus the \$4.17 passed on to the tenant on the lease/sublease, the total general excise tax paid by him was \$87.49, resulting in the taxpayer only receiving \$16.68 on the transaction. The sublease deduction, computed at 87.5% of the amount paid to the landlord, or \$911.46, is allowed as a deduction from the sublease income received of \$1,145.83. The net sublease rental income subject to general excise taxes is \$234.37, resulting in general excise tax liability of \$9.38 to the taxpayer. Therefore, total amount of general excise taxes paid by the taxpayer would be \$51.04 (\$41.66 paid to the landlord plus \$9.38 paid to the Tax Department).

In other words, with the sublease deduction, the taxpayer pays general excise taxes of \$9.38 on the extra \$104.17 he collects from his tenant, or a 9% effective rate. With the suspension of the sublease deduction, the taxpayer pays \$45.83 in general excise taxes on the \$104.17 sandwiched profit, or a whopping 44% rate.

Enterprise Zones

The Act suspends the exemption for gross receipts from activities conducted within Enterprise Zones. Prior to the Act, general contractors were exempt from paying general excise taxes on income received from qualified businesses located within the Enterprise Zones so that these qualified businesses would not incur general excise taxes on these contracts. Now all construction contracts will be subject to general excise taxes until June 30, 2013. Grandfathering rules will be applied to written binding contracts entered into prior to July 1, 2011.

There are many more provisions of the general excise and use tax law suspended for the next two years. If there are questions, please call on us anytime.