

STAND. COM. REP. NO.

2424

Honolulu, Hawaii

FEB 17

, 2006

RE: S.B. No. 2222

S.D. 1

Honorable Robert Bunda
President of the Senate
Twenty-Third State Legislature
Regular Session of 2006
State of Hawaii

Sir:

Your Committee on Media, Arts, Science, and Technology, to which was referred S.B. No. 2222 entitled:

"A BILL FOR AN ACT RELATING TO STREAMLINED SALES AND USE TAX,"

begs leave to report as follows:

The purpose of this measure is to amend the State's tax laws to allow Hawaii to participate in the Streamlined Sales and Use Tax Agreement and consequently collect taxes from electronic commerce transactions.

Testimony in support of the measure was received from the Hawaii Government Employees Association, the Retail Merchants of Hawaii, the Hawaii Association of Realtors, and an accounting firm. The Department of Taxation, the National Association of Insurance and Financial Advisors, and the Tax Foundation submitted comments.

Your Committee finds that, in 2003, the State lost approximately \$115,000,000 in state and local revenue because of an inability to collect use taxes on out-of-state retail transactions, including online sales. Those estimates increase to approximately \$200,000,000 by the year 2008.

In response to this data, the Legislature enacted chapter 255D, Hawaii Revised Statutes, the Hawaii Simplified Sales and Use Tax Administration Act. The Act essentially directed the Department of Taxation to enter into streamlined sales and use tax

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agreements with other states to simplify and modernize the administration of sales and use taxes. The modernization included, among other things, a system to prevent the widespread nonpayment of sales and use taxes owed from out-of-state retail transactions.

Your Committee finds that the implementation of the Streamlined Sales and Use Tax in Hawaii would benefit the State by:

- (1) Increasing the revenue to the General Fund; and
- (2) "Leveling the playing field" for local retailers by bringing equity to the State's retailers that lose sales to Internet or mail order commerce.

The Department of Taxation and the Tax Foundation expressed concern over the following issues regarding the implementation of the Streamlined Sales and Use Tax:

- (1) Added complexity to the State's existing tax system due to Hawaii's use of a general excise tax rather than a sales tax. As such, the State's general excise tax system would have to be significantly modified to accommodate the Streamlined Sales and Use Tax Agreement;
- (2) Providing amnesty to out-of-state sellers that may or may not have a nexus with the State. Doing so would mean that the State would give up its right to pursue these sellers for general excise tax liability on their operations in the State;
- (3) The State must compensate remote sellers who participate in the Streamlined Sales and Use Tax Agreement, but local sellers are not compensated for collecting and paying the tax;
- (4) The State is limiting its ability to adopt legislation that departs from the Streamlined Sales and Use Tax Agreement and its governing board;
- (5) The City and County of Honolulu would have to conform its general excise tax surcharge if the Streamlined Sales and Use Tax Agreement is implemented;



- (6) Under the Streamlined Sales and Use Tax Agreement, the definition of "gross proceeds of sale" would need to be changed to "sales price." Doing so may result in a loss of revenue;
- (7) ITIMS (the Department of Taxation's computer system) is geared to general excise tax and would need major renovations for sales tax or different sourcing rules and modifying ITIMS to accommodate the implementation of the Streamlined Sales and Use Tax Agreement would complicate future development and maintenance; and
- (8) Implementing the Streamlined Sales and Use Tax Agreement would jeopardize or increase risk to other on-going initiatives like imaging, electronic filing, tax law changes, and upgrades.

Your Committee understands the concerns raised by the Department of Taxation and the Tax Foundation. However, your Committee believes that many of the concerns are readily ameliorated and that this measure and the Streamlined Sales and Use Tax Agreement actually address each concern as follows:

- (1) With regard to the issue of added complexity, the legal incidence of the general excise tax is on the seller, but one-third of sales tax jurisdictions also impose the legal incidence of their tax on the seller, so the claim is factually incorrect. The creation of three new tax chapters, as proposed under this measure, actually makes tax compliance simpler for taxpayers because the different tax rates will be in different chapters, as opposed to being buried in a single chapter with all of the different rates (4%, .5%, .15%);
- (2) With regard to amnesty, the reality is that many remote sellers cannot be found. Amnesty dispenses with the need for extensive auditing and the allocation of human resources in exchange for prospective compliance. There are now three hundred twenty-five sellers who participate in the Streamlined Sales and Use Tax Agreement, which will provide a rich base for enhanced collections. In addition, amnesty could also be extended to local sellers to level the playing field;



- (3) With regard to remote seller compensation, this is a misunderstanding of the Streamlined Sales and Use Tax Agreement's Certified Service Provider model, where the State is required to compensate the Certified Service Provider, not the taxpayers. In recent commentary, states were advised to get used to paying for this service, as it will likely be mandated when federal legislation is enacted;
- (4) With regard to the State limiting its ability to adopt legislation that departs from the Streamlined Sales and Use Tax Agreement and its governing board, Hawaii, of all states, needs the least amount of changes to its tax laws for Streamlined Sales and Use Tax Agreement conformity. This is due to the existence of very few, different tax rates. The State:
- (A) Has a large tax base without the food or medical exemptions;
 - (B) Already conforms to destination sourcing; and
 - (C) Already centralizes tax administration.
- Most general excise tax legislation deals with exemptions and pyramiding relief, which would not be impacted by the Streamlined Sales and Use Tax Agreement, provided definitions are consistent;
- (5) With regard to the issue that the City and County of Honolulu will need to conform to state law, your Committee believes conformity is beneficial, as the biggest complaint of businesses in other states concerns having to contend with thousands of different taxing jurisdictions that lack uniform rates, exemptions, sourcing, and tax bases;
- (6) With regard to changing the definition of "gross proceeds of sale" to "sales price," your Committee believes that the definition of "sales price" under the Streamlined Sales and Use Tax Agreement is at least as encompassing as the State's existing definition of "gross proceeds of sale";



- (7) With regard to ITIMS needing major renovations for sales tax or different sourcing rules and that modifying ITIMS will complicate future development and maintenance, the new tax regime, like the old, would rely on the self-assessment system, whereby taxpayers report sales, income, sourcing, and exemptions. The computer fields would remain the same. Taxpayers would still have to report the numbers in those fields. In addition, the computer system would not be affected by amendments to sourcing rules, definitions, and other policy determinations. Your Committee believes that the ability to access previously uncollectable tax revenues outweighs the issue of ITIMS modification concerns; and
- (8) With regard to the issue that implementing the Streamlined Sales and Use Tax Agreement would jeopardize or increase risk to other on-going initiatives like imaging, electronic filing, tax law changes, and upgrades, your Committee notes that, even without implementing the Streamlined Sales and Use Tax Agreement, there are tax law changes and new forms every year, mostly for net income tax, not the general excise tax. Consequently, there will most likely be fewer changes with sales tax than income tax, especially when compared to the 2005 income tax law changes made by Congress.

Your Committee has amended the measure by:

- (1) Defining "direct mail" and inserting language to govern the taxation of direct mail sourcing transactions;
- (2) Replacing references to "agents, general agents, subagents, or solicitors" with the term "insurance producers" in the section of the measure that establishes the apportionment of tax for insurance producers to conform the terminology to that of the Insurance Code;
- (3) Inserting two new sections that amend sections 237-8.6 and 238-2.6(a), Hawaii Revised Statutes, to clarify that a county of the State shall not conduct an independent tax audit of any seller registered under the Streamlined Sales and Use Tax Agreement;



- (4) Rewording the "tax rounding rule" to make it universally applicable to not only tax returns, as it is currently utilized, but also to the amount of tax applied to the sale of a product or service;
- (5) Inserting provisions that govern customer refund procedures under the Streamlined Sales and Use Tax Agreement;
- (6) Inserting an appropriation to the Auditor for the purpose of contracting the services of tax and accounting experts to assist in finalizing and implementing the Streamlined Sales and Use Tax Agreement;
- (7) Allowing contractors contracted by the Auditor to support implementation of the Streamlined Sales and Use Tax Agreement to inspect and receive tax returns, abstracts of tax returns, and other information contained in tax returns, but only for the purpose of conforming the State's general excise and use taxes to the Streamlined Sales Tax Project's Model Agreement and Act; and
- (8) Making numerous technical, nonsubstantive amendments for the purposes of clarity, consistency, style.

Your Committee notes that the majority of substantive amendments made to the measure were executed to ensure conformance with the requirements of the Streamlined Sales and Use Tax Agreement. In addition, your Committee believes that the appropriation to the Auditor is necessary so that the Auditor and the Auditor's contractors may continue their work on ensuring compliance with the Streamlined Sales and Use Tax Agreement.

Your Committee wishes to emphasize that the State must recognize that shopping patterns are changing, and changing rapidly, especially in geographically remote areas like Hawaii. The State cannot ignore this, and the Streamlined Sales and Use Tax Agreement will enable the Department of Taxation and local sellers to keep up with the advances in technology.

As affirmed by the record of votes of the members of your Committee on Media, Arts, Science, and Technology that is attached to this report, your Committee is in accord with the intent and



purpose of S.B. No. 2222, as amended herein, and recommends that it pass Second Reading in the form attached hereto as S.B. No. 2222, S.D. 1, and be referred to the Committee on Ways and Means.

Respectfully submitted on
behalf of the members of the
Committee on Media, Arts,
Science, and Technology,


CAROL FUKUNAGA, Chair



