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HOUSE COMMITTEE ON ECONOMIC REVITALIZATION, BUSINESS & MILITARY AFFAIRS
TESTIMONY REGARDING HB 1586
RELATING TO TAXATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: FEBRUARY 12, 2009
TIME: 7:30AM
ROOM: 312

This measure clarifies the nexus standard for taxing out-of-state businesses on their business activity in Hawaii.

The Department of Taxation (Department) **supports** this measure.

I. THIS LEGISLATION IS THE LATEST DEVELOPMENT IN STATE & LOCAL TAXING AUTHORITY.

The Department supports this measure because it raises the nexus standard for the Legislature's consideration of the latest developments in state and local taxation. The nexus concept is a constitutional principle whereby a State is precluded from taxing a business from out-of-state unless the business has substantial nexus with the taxing state.

Traditionally, nexus was determined by the US Supreme Court case of *Quill v. North Dakota*, 504 US 198 (1992). This case stood for the proposition that an out-of-state business could not be forced to collect use tax unless the business had physical presence. This case is several decades old and has come under recent scrutiny in state and local taxation with two important state Supreme Court cases.

In 2006, two state Supreme Courts found that the Quill physical presence determination was limited to sales and use taxes. *See Tax Comm. v. MBNA*, 640 S.E.2d 226 (WV 2006) and *Lanco, Inc. v. Director*, 908 A.2d 176 (NJ 2006). The primary reason for the limited finding was due to the fact that sales and use taxes are filed and paid on a monthly periodic basis. When the Supreme Court analyzed the tax in *Quill*, it relied on the monthly filing basis to find that the tax unduly burdened interstate commerce. In the *MBNA* and *Lanco* cases; however, the taxes at issue were franchise taxes payable annually. In essence, the courts found that an annual filing and payment requirement did not burden interstate commerce within the meaning of *Quill* and therefore found, in addition to the

business activities in those States, the businesses had nexus and were taxable.

This legislation is timely because, in 2007, the US Supreme Court denied review of the *MBNA* and *Lanco* decisions. Therefore, under current legal standards, there is no further review of these decisions and they are the law in their respective jurisdictions. Other jurisdiction; however, could find their analysis persuasive, which the Department supports.

II. THIS BILL CLARIFIES THE NEXUS STANDARD IN LIGHT OF DEVEOPMENTS IN OTHER STATES.

This legislation proposes to assert a nexus standard similar to the *MBNA* and *Lanco* cases for all Hawaii taxes. When extrapolating the *MBNA* and *Lanco* holdings to this legislation, it would appear constitutional under those standards because the taxpayers are allowed to pay annually (versus monthly or quarterly), minimizing the burden on commerce. And, where a sufficiently high number of customers or amount of revenue is generated from Hawaii, these businesses are rightfully taxable.

III. THIS BILL LEVELS THE PLAYING FIELD.

One of the most important aspects of this legislation is that it levels the playing field for in-state businesses who must comply with Hawaii's state and local tax regimes. Without this legislation, it is possible for an out-of-state business to receive a favorable advantage over an in-state business selling the same items. This legislation would make the taxation for in-state and out-of-state businesses more fair.

IV. OTHER STATES ARE FOLLOWING SUIT

Brief research shows that, soon after the denial of cert. in *MBNA* and *Lanco*, other states including New Hampshire and New York were quick to adopt the economic presence standard. *See attached.*

V. THIS BILL IS NOT A TAX INCREASE; BUT RATHER CLARIFIES THE CURRENT ABILITY TO TAX UNDER CURRENT LAWS.

The Department wants to point out that this measure is not a tax increase, but rather clarifies the boundaries of the taxing authority of the State.

Under current law, the Department is allowed to enforce the law to the extent of the State and US Constitutions. This bill clarifies the Legislature's policy of the extent of these principles.

VI. REVENUE IMPACT

This legislation will result in a revenue gain of approximately $30-$40 million per year. Importantly, this legislation allows for the clarification of current law, a potential revenue increase, without raising taxes.

News Analysis: New Hampshire Adopts Economic Nexus Standard

by Chris Sullivan

Apparently emboldened by the U.S. Supreme Court's denial of certiorari in Lanco and MBNA, the New Hampshire legislature has adopted an economic nexus standard for purposes of its business profits tax.

Date: Jul. 17, 2007

News Analysis

Apparently emboldened by the U.S. Supreme Court's denial of certiorari in *Lanco* and *MBNA*, the New Hampshire legislature has adopted an economic nexus standard for purposes of its business profits tax. The legislature amended the statutory definition of business activity to include "a substantial economic presence evidenced by a purposeful direction of business toward the state," effective July 1.

This action is part of an increasing trend among states to turn their backs on a clear, bright-line physical presence standard (*Quill Corp. v. North Dakota*, 504 U.S. 298 (1992)), in favor of a more nebulous standard focused on the quality and quantity of a company's economic presence in a state's market. See *Geoffrey Inc. v. South Carolina Tax Commission*, 437 S.E. 2d 13 (1993); *Lanco Inc. v. Director*, 908 A.2d 176 (N.J. 2006), *cert. denied*, No. 06-1236 (U.S. June 18, 2007); and *FIA Card Services NA, fka MBNA America Bank NA, v. Tax Commissioner*, 640 S.E.2d. 226 (W.V. 2006), *cert. denied*, No. 06-1228 (U.S. June 18, 2007)).

During the 2007 legislative session, the Senate deferred consideration of the provision while the economic nexus question was pending before the Supreme Court in *Lanco* and *MBNA*. When the Supreme Court denied certiorari on June 18, the Senate yielded to the House position -- just days before the legislative session concluded -- to include the change as part of an amendment to HB 2, the trailer bill, a form of implementing legislation that accompanies the biennial budget bill (HB 1). (For coverage of the Supreme Court's decision not to hear the *Lanco* and *MBNA* cases, see *State Tax Notes*, Jun. 25, 2007, p. 925, *2007 STT 118-1*, or *Doc 2007-14502* [**PDF**]. For HB 2 as enacted, see *Doc 2007-15767* [**PDF**] or *2007 STT 132-21*.)

The Department of Revenue Administration had initiated the effort to change the law. The House Ways and Means Committee report indicated that the economic nexus legislation was merely a technical correction to "tell out-of-state headquartered businesses they must file if they do business in New Hampshire." The official fiscal note accompanying the legislation supported this view, noting that the change would not raise any new revenue.

However, in public testimony before the Senate Ways and Means Committee, the department said failure to adopt the change would "create the perception of a loophole" that could cost the state between $10 million and $100 million. It seems likely the legislation will result in increased department audits of financial service companies, including credit card companies, mortgage companies, and intellectual property licensing companies.

Interestingly, the law change may hamper the department's ability to pursue economic nexus claims against companies for tax years before the July 1, 2007, effective date. Under traditional rules of statutory construction, legislatures do not enact meaningless measures or add superfluous phrases. Therefore, a taxpayer (particularly one contacted by the department in the future regarding previous tax years) may take the position that jurisdiction based on economic nexus is not authorized by the prior definition of business activity. The department likely would vigorously object to this argument.

Perhaps more important, businesses are reminded that no effort by a state to expand its tax jurisdiction may overcome limits on state tax jurisdiction imposed by the U.S. Constitution and preemptive federal statutes such as Public Law 86-272.

Chris Sullivan, Rath, Young and Pignatelli P.C., Concord

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State Income Tax ALERT

Vol. XVI, No. 12, July 15, 2007

INSIDE

COMING IN FUTURE ISSUES

- Plans in the works to rewrite UDITPA

■ BAT LEGISLATION REINTRODUCED

High Court denies *cert* in *Lanco* and *MBNA* cases

To the major disappointment of taxpayers and some revenue department officials, the U.S. Supreme Court has denied requests to decide whether the Commerce Clause permits a state to impose corporate income and franchise taxes on companies with no physical presence within its borders. The question was raised in separate petitions in which taxpayers sought review of decisions by the highest courts of New Jersey (*Lanco*) and West Virginia (*MBNA*).

Case history

In *Quill* (1992), the U.S. Supreme Court held that a state could not impose a sales and use tax collection obligation on a corporation unless it had a physical presence in the state. Since that time, states and businesses have litigated whether this physical presence standard applies to taxes other than sales and use taxes. State courts have answered this question differently. Court decisions in New Jersey, New Mexico, North Carolina, Ohio, Oklahoma, South Carolina, Washington and West Virginia have limited the physical presence standard to the sales and use tax context, while courts in Michigan, Tennessee and Texas have extended the standard to other taxes.

In *Lanco* (2006), the New Jersey Supreme Court held that New Jersey may apply its corporation business tax to income from the licensing of intangibles in the state, even though the taxpayer (the licensor) lacked physical presence in New Jersey. The court ruled that *Quill* was not intended to create a universal physical presence requirement for state taxation under the Commerce Clause and should be limited to sales and use taxes.

In *MBNA America Bank, N.A.*(2006) (now *FIA Card Services, N.A.*), the West Virginia Supreme Court of Appeals held the state could impose corporate net income and business franchise taxes on a bank's gross receipts from West Virginia customers, even though the bank had no physical presence in the state. The court concluded that *Quill* is limited to sales and use taxes. Furthermore, it held that a significant economic presence test is a better indicator of whether substantial nexus exists for Commerce Clause purposes than a physical presence standard. The bank's activity directed toward the state, including direct mail and telephone solicitations, produced significant gross receipts from West Virginia customers and, therefore, satisfied the significant economic presence test, according to the court.

When, if ever?

Many—including **Paul Frankel**, a partner with **Morrison & Foerster LLP** in New York, who argued the case for Lanco—had hoped that *Lanco* and *MBNA* would be the cases that would result in a definitive answer as to whether physical presence is required for income tax nexus.

"[Lanco] has no comment, but my personal view is I am disappointed, but the issue will be back," Frankel predicts. "Cases are working their way up in several other states and I think that the issue will eventually be taken by the U.S. Supreme Court, and they will rule for the taxpayer."

Richard Pomp, a professor at the **University of Connecticut Law School**, is also disappointed with the Supreme Court's denial of *cert* in these two cases.

"Taxpayers will continue to be forced to litigate this burning issue," he says. "It is regrettable that the court is either waiting for Congress to act or is content with the recent direction of the cases. Perhaps it is just my narrow biased perspective, but I cannot fathom why the court granted *cert* in *Knight*, involving whether a trustee's payment of fees to an investment adviser is subject to the 2% floor, but rejected *Lanco* and *MBNA*. Let's hope they will find *Mead* and *GE* [state tax cases for which *cert* has been requested] more to their liking."

Philip Tatarowicz, a partner with **Ernst & Young LLP** in Washington, believes that eventually the High Court may hear a physical presence case if the circumstances are right.

"The brief that was filed in *MBNA* by the state raised some questions about whether there really is a [controversy] at the *highest* state court level among the states," he points out. "The decisions in Tennessee and Michigan, for example, were appellate court decisions where the state's highest court had declined to review the lower court's decision, so it became final in that respect rather than a decision issued directly by the state's highest court. If there evolves a decision by a state's highest court holding that a physical presence is required, and the state appeals to the U.S. Supreme Court, any doubt of conflict between the states would not be at issue. Or if a case involved a taxpayer from outside the United States operating in the United States so that foreign commerce was involved, that might pique the interest of the court."

Another viewpoint

Joe Huddleston, executive director of the **Multistate Tax Commission**, is not surprised the Supreme Court declined to hear the *Lanco* and *MBNA* cases.

"I think it is a clear trend over the last decade or more in the states that the courts have repeat-

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edly found that physical presence is not, and has never been, the legal standard for corporate income tax," he says. "Historically the role of the court has been to take legitimate controversies; it's not been one to give a political foundation for one perspective or another. Its role is to resolve legitimate constitutional questions, and this is just not one. They may never take one of these cases unless there comes a time when there is a great deal of controversy between the states on this issue. I think that those people who are proponents of [BAT nexus] legislation will use this as an excuse to try to reenergize the special interests that want it, but the practical reality is that the concepts of physical presence have no real meaning in today's economy."

Already a BAT bill

Shortly after the High Court denied *cert* in *Lanco* and *MBNA*, The Business Activity Tax Simplification Act of 2007 (S1726) was introduced in the U.S. Senate by Sens. Charles Schumer, D-N.Y., and Mike Crapo, R-Idaho. According to an accompanying press release, the legislation was introduced, in part, as a response to the Supreme Court's refusal to resolve the physical presence nexus controversy by accepting the *Lanco* and *MBNA* petitions for review.

Under the legislation, the protections of Public Law 86-272 would be expanded and a physical presence nexus standard would be codified for business activity taxes. It is similar to legislation introduced in previous sessions of Congress.

The legislation would prohibit a state from imposing a business activity tax unless the taxpayer has a physical presence in the state for more than 15 days during the year. Presence in a state "to conduct limited or transient business activity" would not establish physical presence.

The proposed legislation would extend the prohibition of PL 86-272 to all business activity taxes, not just net income taxes as is currently the case. Also, it would include in protected activity solicitations with respect to any sale or transaction approved and fulfilled outside the state, including transactions involving intangible property and services. Currently, PL 86-272 only applies to solicitations for sales of tangible personal property.

KEY TAKEAWAY POINTS

The U.S. Supreme Court's denial of *cert* in *Lanco* and *MBNA* means that the law in New Jersey is *Lanco* and the law in West Virginia is *MBNA*. However, the question of whether physical presence is required for income tax nexus remains open in any state that does not have a final court decision on the issue. Other cases are working their way up through the court system, and legislation has been introduced that would impose a physical presence requirement for all business activity taxes.

Protected activity would also include furnishing information, covering events, or gathering information in a state when the information is used or disseminated from outside the state, and include activities related to the purchase of goods or services in a state if the final decision to purchase is made outside the state.

Arthur Rosen, a partner with **McDermott Will & Emery LLP** in New York, who, along with Donald Griswold with the same firm, represents MBNA, is a proponent of the legislation.

"The Supreme Court denial of *cert* shows that virtually every business in the country has to be worried about paying tax to every jurisdiction where they merely have customers," Rosen warns. "It reinforces that it is a job for Congress to do, that protecting interstate commerce was given by the Constitution to the Congress to protect. That is why it is so important for the business community to support Congressional action to resolve this problem so that businesses pay tax only to jurisdictions that provide them with meaningful benefits and protections. We think there has always been quite a bit of support; it's just that little businesses and many others who are interested in preserving interstate commerce have not been actively involved, perhaps because they expected the court to take care of it. But now that they have seen the court has declined to do that, we would hope that they would act on their support and let Congress know how important this is to the American economy."

The bottom line

Sometime in the future the High Court may take an income tax case dealing with physical presence, or the BAT nexus legislation may be passed, but in the meantime, what is the significance of the denial of *cert* in *Lanco* and *MBNA*?

"Clearly, in New Jersey and West Virginia those decisions are final so taxpayers with fact patterns that are similar to Lanco and MBNA will need to evaluate how to deal with those issues in New Jersey and West Virginia, not only for tax purposes but if they use GAAP for financial reporting purposes," Tatarowicz notes. "For states outside of the two that were directly impacted here, it is status quo. There are some states that have held that physical presence is required, but unless a state adopts a bright-line physical presence test, taxpayers will need to continue to look at their facts and circumstances very closely. It is going to continue to add uncertainty, not only to taxpayers, but to state administrators."

"The most important thing is that all *'cert* denied' means is that four justices didn't think it was time to take the issue," Frankel points out. "It is not being affirmed. It means that the law in New Jersey is *Lanco* and the law in West Virginia is *MBNA*, but there are many states that haven't ruled yet and it is wide open."

Editor's note: *Frankel can be reached at (212) 468-8034 or pfrankel@mofo.com, Pomp at (860) 570-5251 or rpomp@law.uconn.edu, Huddleston at (202) 624-8699 or jhuddleston@mtc.gov, Tatarowicz at (202) 327-5765 or philip.tatarowicz@ey.com, Rosen at (212) 547-5596 or arosen@mwe.com.*◆

Massachusetts ATB addresses physical presence issue

The Massachusetts Appellate Tax Board determined recently that the imposition of the state's financial institution excise tax was valid where taxpayers derived substantial economic gain from the use of the state's economic market, infrastructure and resources.

Every financial institution engaged in business in Massachusetts must pay an excise measured by its net income. The taxpayers in *Capital One Bank* (two credit card banks), were statutorily deemed to be engaged in business in the state because they conducted activities with 100 or more Massachusetts residents and had receipts exceeding $500,000 attributable to state sources. The taxpayers challenged the constitutionality of the imposition of the excise tax because they did not have physical presence in the state.

Physical presence not required

The ATB rejected the argument that the Commerce Clause of the U.S. Constitution requires a corporation to have physical presence in a state before the state may impose an excise measured by the corporation's net income. The board based its determination on federal and state case law that provides a state may, consistent with the Commerce Clause, impose a tax on a company engaged in purely interstate commerce provided that the tax is applied to an activity with a substantial nexus with the taxing state. The taxpayers had substantial nexus with Massachusetts because they engaged in the following activities:

- targeted marketing of their credit card business to Massachusetts customers,
- quarterly filing of the required Credit Card Issuer's Reports with the state,
- using the state's court system and Attorney General's Office to collect delinquent accounts and resolve disputes,
- using a network of state banks to link them to in-state customers and merchants,
- guaranteeing of payment to merchants on behalf of in-state customers, and
- deriving hundreds of millions of dollars in income from transactions involving in-state residents and merchants.

The taxpayers also challenged the financial institution excise tax under the Massachusetts Constitution. In order for an excise to be constitutional in the state, it must be reasonable and it must be levied upon produce, goods, wares, merchandise or commodities. The argument that the tax failed this test was rejected by the ATB because it determined that the excise is uniformly and reasonably imposed in exchange for the privilege of conducting business in the state.◆

California amnesty developments

The California Assembly has passed AB561, which would revise provisions of the corporation franchise and income tax amnesty program administered by the Franchise Tax Board for the period beginning Feb. 1, 2005, through March 31, 2005, to provide taxpayers with relief from certain unintended consequences of the program. Specifically, the bill would:

L E G I S L A T I V E

TAXBILLSERVICE

126 Queen Street, Suite 304 TAX FOUNDATION OF HAWAII Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: ADMINISTRATION, Taxation of out-of-state businesses

BILL NUMBER: SB 1325; HB 1586 (Identical)

INTRODUCED BY: SB by Hanabusa by request; HB by Say by request

BRIEF SUMMARY: Adds a new section to HRS chapter 231 to provide that a person or entity conducting business in the state that is located out of state shall be presumed to be systematically and regularly engaging in business in this state and taxable under title 14 if during any year: (1) the person or entity engages in or solicits business with 20 or more persons within this state; or (2) the sum of the value of the person or entity's income, gross proceeds, gross rental, or gross rental proceeds attributable to sources in this state equals or exceeds $100,000.

If the person or entity is subject to taxation as a result of this section, the person or entity may petition the director of taxation to allow the assessment and remitting of tax on a basis other than monthly for good cause. For purposes of this section, good cause includes compliance with the Constitution of the United States and compliance with the Constitution of the state of Hawaii.

EFFECTIVE DATE: July 1, 2009

STAFF COMMENTS: While it appears that this measure is proposing to impose the general excise tax an out-of-state business that engages in business with 20 or more persons in the state or derives gross income of at least $100,000 attributable to sales to Hawaii, it should be remembered that all sales of tangible personal property or services purchased from a business located out-of-state are currently subject to tax under Hawaii's use tax law.

It should be remembered that while the general excise tax is imposed on the sale of all goods and services purchased in the state, the use tax was enacted to place out-of-state vendors on an equal footing with in-state licensed vendors who are subject to the general excise tax.

While items purchased by residents of the state from out-of-state businesses are subject to the use tax, the department of taxation admitted that enforcement of the use tax on such items of a personal nature would be difficult. The only item that requires the verification of the payment of the use tax is a motor vehicle purchased from an out-of-state business. It was believed that if the taxpayer purchased a motor vehicle from a state that did not impose a sales tax on the price of a vehicle, the purchase would be tax free putting the local automobile dealers at a competitive disadvantage. Thus, when the purchaser of that vehicle attempts to register the vehicle in Hawaii, he would have to provide proof that Hawaii's use tax was paid before it could be registered in Hawaii.

While it is recognized that tons of tax-free sales are made through the Internet and that the taxation of such sales constitutes a large revenue stream, discussion of the taxing of Internet sales transactions is under serious consideration.

Digested 2/11/09

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THE HOUSE OF REPRESENTATIVES
THE TWENTY-FIFTH LEGISLATURE
REGULAR SESSION OF 2009

COMMITTEE ON ECONOMIC REVITALIZATION, BUSINESS, & MILITARY AFFAIRS

Hearing February 11, 2009
Testimony on H.B. 1586
(Relating to Taxation)

Chairs McKelvey, Vice-Chair Choy and members of the Committee:

My name is Peter Fritz. I am an attorney specializing in tax law. I was also an Administrative Rules Specialist under Directors Kamikawa, Okamura and Kawafuchi. I am testifying as a taxpayer and concerned citizen.

I am opposed to this bill because:

1. This bill imposes an obligation creates a nexus standard for out-of-state businesses.

2. It is more likely than not that Supreme Court's decision in Quill v. North Dakota 504 U.S. 298 (1992) which held that under the Commerce Clause of the Constitution, the nexus standard requires an in-state physical presence on the part of the retailer.

3. In order to satisfy the nexus requirements of Quill, something more than solicitations of sales by a remote seller is required. In other words, merely soliciting sales alone or doing more than $100,000.00 will not subject a remote seller to GET liability.

4. There must be something more, such as an out-of-state retailer using an in-state agent to perform services on its behalf, to cause the remote seller to have nexus in the state. This is referred to as "attributional nexus."

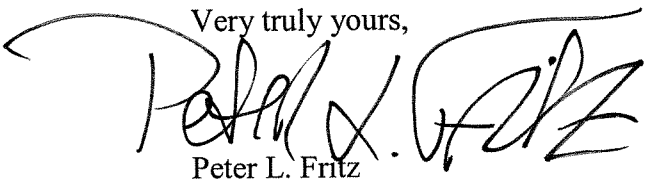
5. Enacting this bill as written will put the Department of Taxation in the position having to enforce a law that violates the United States Constitution.

6. he Hawaii resident would have to pay under Chapter 238, Hawaii Revised Statutes.

7. I respectfully request that this bill be held.

Thank you for the opportunity to testify.

Very truly yours,



Peter L. Fritz