L E G I S L A T I V E

# TAXBILLSERVICE

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SUBJECT: ADMINISTRATION, USE, Penalty provisions; taxation of out-of-state businesses

BILL NUMBER: SB 2226, HD-1

INTRODUCED BY: House Committee on Economic Revitalization and Business

BRIEF SUMMARY: Amends HRS sections 231-36.4, 231-36.6 and 231-36.8 to prevent the multiple imposition of the penalty provision of 20% on any underpayment that is imposed under HRS section 231-36 (false and fraudulent statements), HRS section 231-36.4 (willful failure to collect and pay over tax); HRS section 231-36.6 (substantial understatements or misstatements of amounts) or HRS section 231-36.8 (erroneous claim for refund or credit). These sections shall be applicable to tax years beginning after December 31, 2011.

Adds a new section, paragraph (g), to HRS section 238-6 to provide that the use tax shall not be collected by a seller engaged in business in the state if: (1) the seller can demonstrate that the person in the state with whom the seller has an agreement did not engage in referrals in the state on behalf of the seller that would satisfy the requirements of the commerce clause of the U.S. Constitution; (2) the person in the state with whom the seller has an agreement did not engage in any activity within the state that was significantly associated with the seller's ability to establish or maintain the seller's market in the state during the preceding twelve months.

Defines "engaged in business in the state" to mean a seller, including an entity affiliated with a seller within the meaning of Section 1504 of the Internal Revenue Code (IRC), that has substantial nexus in the state for purposes of the commerce clause of the U.S. Constitution which would permit the state to impose the use tax, and includes: (1) any seller that is a member of a commonly controlled group that includes an entity that has a substantial nexus with the state and: (A) sells a similar line of products as the seller and does so under the same or similar business name; or (B) uses trademarks, service marks, or trade names in the state that are the same or substantially similar to those used by the seller; (2) any seller entering into an agreement under which any person, other than a common carrier acting in its capacity, that has substantial nexus in this state and that: (A) delivers, installs, assembles, or performs maintenance services for the seller's customers within this state; or (B) facilitates the seller's delivery of property to customers in the state by allowing the seller's customers to pick up property sold by the seller at an office, distribution facility, warehouse, storage place, store front, or similar place of business maintained by the in-state person; (3) any seller that is a member of a commonly controlled group that includes another member that performs services in the state in connection with tangible personal property to be sold by the seller, including the design and development of tangible personal property sold by the seller, or the solicitation of sales of tangible personal property on behalf of the seller; and (4) any seller entering into an agreement where a person in the state, for a commission or other consideration, refers potential purchasers of tangible personal property to the seller, whether by an internet-based link or an internet website provided that: (A) the total cumulative sales price from all of the seller's sales, within the preceding twelve months of tangible personal property to purchasers in the state is in excess of $10,000; and (B) the seller, within the preceding twelve months, has total cumulative sales of tangible

personal property to purchasers in the state in excess of $20,000. Specifies that these conditions of "engaged in business" shall be subject to the use tax.

An agreement under which a seller purchases advertisements from a person in the state, to be delivered on television, radio, in print, or on the internet, shall not be considered an agreement for the purposes of this paragraph unless the advertisement revenue paid to the person in the state consists of commissions or other consideration that are based upon sales of tangible personal property. An agreement where a seller engages a person in the state to place an advertisement on an internet web site operated by that person, or operated by another person in the state, is not an agreement for the purposes of this paragraph unless the person entering the agreement with the seller also directly or indirectly solicits potential customers in the state through use of flyers, newsletters, telephone calls, electronic mail, blogs, microblogs, social networking sites, or other means of direct or indirect solicitation specifically targeted at potential customers in the state.

Requires the director of taxation, prior to the convening of the 2013 regular session of the legislature, to certify in writing to the governor and the legislature whether federal law has been enacted by December 31, 2012 authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller.

Defines "commonly controlled group" for purposes of the measure.

This section shall take effect on July 1, 2112 if the state does not, by June 30, 2013, enact a law in accordance with any federal law authorizing the states to require a seller to collect taxes on sales of goods to in-state purchasers without regard to the location of the seller.

EFFECTIVE DATE: July 1, 2112

STAFF COMMENTS: This measure proposes to prohibit the imposition of multiple penalties. Act 166, SLH 2009, established penalties of 20% of the: (1) portion of any underpayment for an understatement of a taxpayer's tax liability; and (2) excessive amount of the filing of a claim for refund or credit in the event of an erroneous claim for refund or credit. While it appears that multiple penalties for more than one violation of the underpayment provisions may be imposed under the state law, federal laws prohibit the imposition of more than one penalty even though they are attributable to more than one violation. Adoption of this provision would allow taxpayers to mitigate their burden of an underpayment penalty similar to the federal treatment of a like infraction.

On the other hand, because the department of taxation does have the discretion to waive excessively high penalties, permitting the stacking of penalties for criminal offensives such as provided under HRS 231-36 (substantial understatement of income) and HRS 231-36.4 (wilful failure to pay and collect) may be an effective deterrent to other taxpayers who may intentionally attempt to avoid paying their tax obligations.

This measure provides that the definition of engaging in business shall include a seller, including an entity affiliated with a seller that has substantial nexus in the state and includes: (1) a seller that is a member of a commonly controlled group that includes an entity that has a substantial nexus with the state and sells a similar line of products as the seller with the same or similar trademarks, service marks, or trade names; (2) a seller entering into an agreement under which any person, other than a common

carrier acting in its capacity, that has substantial nexus in this state that delivers, installs, assembles, or performs maintenance services for the seller's customers within this state or facilitates the seller's delivery of property to customers in the state by allowing the seller's customers to pick up property sold by the seller at any place of business maintained by the in-state person; (3) a seller that is a member of a commonly controlled group that includes another member that performs services in the state in connection with tangible personal property to be sold by the seller, including the design and development of tangible personal property sold by the seller, or the solicitation of sales of tangible personal property on behalf of the seller; and (4) any seller entering into an agreement under which a person, for a commission or other consideration, refers potential purchasers of tangible personal property to the seller. Should that in-state person refer potential purchasers of tangible personal property to the seller by an internet-based link or internet website, and receive a commission or other consideration, provided that: (a) the total cumulative sales from all of the seller's sales, within the preceding twelve months, of tangible personal property to purchasers in the state that are referred pursuant to all of those agreements with a person in the state, are in excess of $10,000; and (b) the seller, within the preceding twelve months, has total cumulative sales of tangible personal property to purchasers in the state in excess of $20,000; then the seller will be considered to be engaging in business in the state. However, it is questionable whether the seller would be subject to the general excise tax or use tax. If the intent of this measure is to subject the sales of the seller to the general excise tax, then these provisions should be inserted into HRS chapter 237 rather than HRS chapter 238.

This approach to collecting the general excise or use tax on out-of-state purchases deserves serious consideration as an alternative to the proposed "streamlined sales tax" project that places the onus of the burden on the seller to collect the tax from the consumer. This approach is a work in progress and serious consideration should be given to refining the provisions of this proposal. However, it is far superior to the approach of the "streamlined sales tax" in that it continues to maintain the structure and philosophy of the general excise tax rather than attempting to change Hawaii's tax into a "sales tax."

It should be noted that "nexus" has been the defining standard as to whether a company must collect and remit sales and/or use taxes. **Quill Corp. v. North Dakota, 504 U.S. 298 (1992)** is a Supreme Court ruling concerning use tax. Quill Corporation is an office supply retailer that had no physical presence in North Dakota, but it had a licensed computer software program that some of its North Dakota customers used for checking Quill's current inventories and placing orders directly. North Dakota attempted to impose a use tax on Quill, which was struck down by the Supreme Court that ruled that a business must have a physical presence in a state for that state to require its sales tax to be collected. If Congress overturns the Quill decision by enacting legislation that would not require such a standard, all companies would have to begin collecting and remitting the appropriate sales tax on sales in interstate commerce.

This bill mirrors many others that have been adopted by other states in recent years. Leading the way has been New York which adopted a similar measure more than four years ago and has been collecting its sales tax on such cross-border sales from vendors who have no physical presence in that state. California reached an agreement with Amazon.com recently and will be requiring that internet giant to begin collecting its sales taxes on purchases made by its residents from that vendor in September. And just last month, the governor of Maryland announced that an agreement had been reached with Amazon and other stakeholders including the "brick and mortar" retailers of Maryland with the adoption of a measure that will require out-of-state vendors to collect sales taxes on the sale of goods to instate customers by out-of-state vendors.

The proposed amendment further strengthens the identification of an out-of-state vendor gaining "physical presence" in the state which again was the turning point in the case of ***Baker & Taylor v. State of Hawaii (2004)*** where the Hawaii Supreme court affirmed that the vendor had gained physical presence in the state and therefore was subject to the general excise tax even though they had no goods or inventory in the state as the title to those goods had passed outside the state. This latter point was the basis for the Court's recognition that the taxpayer, while subject to the general excise, was not necessarily subject to the use tax as it did not cause the goods to be imported into the state.

A recent study of the issue entitled "Collecting Hawaii's General Excise Tax on E-commerce" was issued by this office and provides a status report based on the end of the last calendar year as to where other states are in requiring the collection of their state sales taxes by out-of-state vendors. The study also notes that adoption of this measure does not represent a tax increase, but a mechanism by which taxes already due under the general excise/use tax can be collected. More importantly, the study underscores the fact that Hawaii does not have a retail sales tax structure like the forty some other retail sales tax states and that adoption of this approach to the collection of taxes from out-of-state vendors preserves the integrity of Hawaii's unique general excise tax, something that the Streamlined Sales Tax Project tends to ignore.

Digested 3/30/12

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April 2, 2012

**The Honorable Marcus R. Oshiro, Chair**
House Committee on Finance
State Capitol, Room 308
Honolulu, Hawaii 96813

**RE: S.B. 2226, S.D.2, H.D.1, Relating To Taxation**

**HEARING: Monday, April 2, 2012 at 3:00 p.m.**

Aloha Chair Oshiro, Vice Chair Lee and Members of the Committee:

I am Craig Hirai, a member of the Subcommittee on Taxation and Finance, here to testify on behalf of the Hawai'i Association of REALTORS® ("HAR"), the voice of real estate in Hawai'i, and its 8,500 members in Hawai'i. HAR **supports the intent of Section 4** of S.B. 2226, S.D.2, H.D.1, Relating to Taxation, which requires the collection of use taxes by sellers of tangible personal property who enter into agreements under which a person in the State refers potential purchasers to the seller, including by an internet link or web site, or performs related services in the State on behalf of the seller, unless preempted by federal law.

Currently, many states and municipalities are encountering unprecedented budget deficits. In order to meet their obligations many public agencies must either cut jobs and services or raise revenue from increasing sales taxes, property taxes or other business fees. Proposed federal legislation may give the states the power to collect revenue they are owed and help offset current budget shortfalls – all without costing the federal government a dime.

Every day, brick-and-mortar retailers of all sizes collect and remit sales taxes, putting them at a significant competitive disadvantage to online and catalogue retailers who continue to reap the benefits from an antiquated and biased system. Proposed federal legislation may provide a fairer and more transparent market for community based retailers and it will help keep our downtowns vibrant by protecting much needed local jobs, promoting community investment and maintaining access to essential goods and services in our neighborhoods.

HAR therefore supports the intent of Section 4 of S.B. 2226, S.D.2, H.D.1, to the extent that it may become consistent with any proposed federal legislation.

Mahalo for the opportunity to submit testimony.

Representative Marcus Oshiro, Chair
Representative Marilyn Lee, Vice Chair
Committee on Finance
State Capitol, Honolulu, Hawaii 96813

HEARING Monday, April 02, 2012
3:00 pm
Conference Room 308
Agenda #2

**RE: SB2226, SD2, HD1, Relating to Taxation**

Chair Oshiro, Vice Chair Lee, and Members of the Committee:

Retail Merchants of Hawaii (RMH) is a not-for-profit trade organization representing 200 members and over 2,000 storefronts, and is committed to support the retail industry and business in general in Hawaii. Through November 2011, retail generated $25.6 billion in sales and paid over $1 billion in GET. The retail industry is one of the largest employers in the state, employing 25% of the labor force.

RMH supports SB2226, SD2, HD2, which prohibits penalties for substantial understatements or misstatements and for erroneous claims for refund or credit from being added to tax underpayments on which certain other penalties are already imposed. Unless preempted by federal law, requires the collection of use taxes by sellers of tangible personal property who enter into agreements under which a person in the State refers potential purchasers to the seller, including by an internet link or web site, or performs related services in the State on behalf of the seller.

We are in an era of omnichannel retailing, with brick and mortar retailers leveraging innovative digital technologies to improve the consumer experience. But unlike our omnichannel counterparts, brick and mortar retailers must comply with 7,600 different state and local sales tax systems.

As electronic commerce continues its dramatic increase, traditional brick and mortar retailers are experiencing continued erosion of their sales base to remote sellers, which, under most circumstances, are not subject to tax mandates. SB2226, SD2, HD1 will level the playing field. The unfair disadvantage our Hawaii retailers are experiencing results in unrealized sales, lower tax revenue to the state and minimized revenue and resources to expand their operations and create jobs.

Twelve states enacted e-fairness and/or consumer use laws since 2008: New York, Rhode Island, North Carolina, Colorado, Oklahoma, Illinois, South Dakota, Arkansas, Connecticut, Vermont, California and Texas. Ten other states have legislation pending in 2012: Arizona, Florida, Georgia, Michigan, Minnesota, Missouri, New Jersey, Virginia, Utah and Hawaii.

The reality is that the State of Hawaii has considerable liabilities and unfunded mandates that cannot be satisfied without additional revenue or cutting essential services. It is more than reasonable to collect a tax that's already due before instituting new taxes on everyone. Tax revenue generated from online sales can be used to pay down deficits and get Hawaii back on track toward fiscal solvency.

We respectfully request that you pass SB2226, SD2, HD1. Thank you for your consideration and for the opportunity to comment on this measure.

Carol Pregill, President

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**TO:** Representative Marcus R. Oshiro
Chair, Committee on Finance
Hawaii State Capitol, Room 306
***Via Capitol Web Page***

**FROM:** Mihoko E. Ito

**DATE:** April 1, 2012

**RE:** **S.B. 2226, SD2, HD1 – Relating to Taxation**
**Hearing Date: Monday, April 2, 2012 at 3:00 p.m., Agenda #2**
**Conference Room 308**

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Dear Chair Oshiro and Members of the Committee on Finance:

I am Mihoko Ito, an attorney with Goodsill Anderson Quinn & Stifel, submitting comments on behalf of Walgreen Co. ("Walgreens"). Walgreens operates more than 8,200 locations in all 50 states, the District of Columbia and Puerto Rico. In Hawai`i, Walgreens now has 11 stores on the islands of Oahu, Maui and Hawai`i.

Walgreens **supports** S.B. 2226, SD2, HD1, which requires the collection of use taxes by sellers of tangible personal property who enter into agreements under which a person in the State refers potential purchasers to the seller, including by an internet link or web site, or performs related services in the State on behalf of the seller unless preempted by federal law.

Walgreens believes that all retailers can conduct their business in a fair, competitive environment. Walgreens supports this measure to the extent that it seeks to level the playing field so that local "brick-and-mortar" stores operate under the same rules and online sellers.

Thank you very much for the opportunity to submit comments regarding this measure.

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**THE SENATE**
**THE TWENTY-SIXTH LEGISLATURE**
**Regular Session of 2012**

**COMMITTEE ON FINANCE**
**Chair Oshiro, Vice Chair Lee, Members of the Committee**

**Hearing Date: Monday, April 2, 2012**
**Testimony on SB 2226 SD 2 HD1 (Relating to Taxation)**

Chair Oshiro, Vice Chair Lee, Members of the Committee:

We urge passage of this HD1 version of the bill as it relates to "tax penalty stacking." HD1 would prohibit penalties for wilful failure to collect and pay taxes, substantial understatements or nisstatements, and erroneous claims for refund or credit from being added to tax underpayments on which certain other penalties are already imposed.

Many new tax penalties were enacted in 2009 through the passage of Act 166. While these penalties are similar to those imposed under the federal Internal Revenue Code, the federal provisions do not stack onto one another for the same violation. This bill will ameliorate the impact of these penalties by prohibiting the assessment of multiple penalties relating to the same tax error.

Thank you for affording me the opportunity to testify.

Very truly yours,

CHUN, KERR, DODD, BEAMAN & WONG,
a Limited Liability Law Partnership

Ray Kamikawa

148287.1

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**HOUSE OF REPRESENTATIVES**
**THE TWENTY-SIXTH LEGISLATURE**
**REGULAR SESSION OF 2012**

**COMMITTEE ON FINANCE**

**Hearing Date: April 2, 2012**
**Time: 3:00 PM**
**Testimony on SB 2226, SD2, HD 1**
**(Relating to Taxation)**

Chair Oshiro, Vice-Chair Lee, and members of the Committee, thank you for the opportunity to testify in **support of the intent of Section 1 of SB 2226, SD2, HD 1.**

This purpose Section 1 of this bill is to incorporate certain language in Internal Revenue Code ("IRC") that prevents one penalty from stacking on top of another penalty into the analogous provisions in Hawaii law.

While I support the intent of Section 1 of this bill, I recommend that the relevant language of HB 1695 SD 1 be inserted into Section 1. The language in HB 1695 SD 1 incorporates comments made by the Department of Taxation.

Thank you for the opportunity to testify.

Respectfully,

Peter L. Fritz