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To: The Honorable Karl Rhoads, Chair  
and Members of the House Committee on the Judiciary

Date: Tuesday, February 11, 2014  
Time: 2:00 P.M.  
Place: Conference Room 325, State Capitol

From: Frederick D. Pablo, Director  
Department of Taxation

Re: H.B. No. 1651 Relating to Taxation

The Department of Taxation (Department) has serious concerns regarding H.B. 1651, and provides the following comments for your consideration.

H.B. 1651 requires collection of Use Tax 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.

The Department first notes that legislation similar to H.B. 1651 has been challenged in other states, and that the outcome of those challenges has left the suitability of such legislation in question. The two most prominent examples where states are facing challenges to similar laws are: 1) New York, in which the state's law was upheld by the state's highest court; and Illinois, in which the state's law was held by the state's highest court to be preempted by federal law. Due to the legal uncertainty, the Department has concerns about the legality of the changes suggested by H.B. 1651.

Second, H.B. 1651 would require collection of the Use Tax by entities that have a relationship with out-of-state retailers that are selling tangible personal property into the State. It is very important to note that requiring the seller to collect the Use Tax from consumers means that the retailer does not have nexus with Hawaii and is not subject to General Excise Tax (GET). It is the Department's position that physical presence is not necessary to be subject to GET. The Department is concerned that legislation like this measure may be interpreted to mean that GET will not be imposed on remote sellers; in other words, that an affiliated entity was needed just to require Use Tax collection.

Third, the Department believes that the preservation of the breadth of the GET statutes is of utmost importance. Hawaii does not have a sales tax and compensating use tax, as are found in nearly all other states. Instead, GET is a gross income tax on the privilege of doing business, with a unique Use Tax to compliment the GET. Because Hawaii does not have a sales tax, it is not as limited as other jurisdictions with regards to what activity may be taxed. In terms of state taxes on economic activity, the GET's reach is as broad as possible, and the Use Tax (which is collected from consumers), is designed to only reach the transactions that the GET cannot.

The only time that GET cannot be imposed is when a specific exemption/exclusion applies, or when there is no nexus. The GET and the Use Tax, by their terms, cannot apply to the same transaction. Nexus is a somewhat amorphous concept, based on United States Supreme Court case law interpreting the Commerce Clause of the United States Constitution. Defining "nexus" by statute cannot be done effectively, as it depends on many different factors, and on the unique circumstances of each case.

Finally, even if a measure such as H.B. 1651 withstood a federal challenge, there is no reason to believe that it would remedy the bigger issue of whether online retailers having a tax advantage over brick and mortar retailers. Entities that do have contractual arrangements that would be subject to this measure could simply cancel their agreements.

In short, the Department believes that H.B. 1651 is unnecessary at this time because there is a question as to whether such statutes are allowable under Federal law; whether the proposed changes may actually hinder the Department's ability to pursue otherwise taxable transactions; and the probability that these types of measures will remedy the bigger issues facing brick and mortar retailers today.

Thank you for the opportunity to provide comments.

# TAXBILLSERVICE

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TAX FOUNDATION OF HAWAII

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

BILL NUMBER: HB 1651

INTRODUCED BY: Choy

**BRIEF SUMMARY:** 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 is 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 2015 regular session of the legislature, to certify in writing to the governor and the legislature whether federal law has been enacted by December 31, 2014 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 act shall take effect on July 1, 2015 if the state does not, by June 30, 2015, 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: Upon approval

STAFF COMMENTS: This measure is an attempt to define statutorily what kinds of activities constitute substantial nexus for purposes of the general excise and use taxes. However, for the reasons that follow, the measure is not necessary because Hawaii statutes and case authorities have already held that Hawaii is allowed to tax to the limit of its Constitutional ability to do so.

The United States Constitution has been interpreted as providing two limits on the states’ powers to tax. These limits come from at least two places: first, the Due Process Clause, requiring a person to have “minimum contacts” with a state before that state is allowed to exercise police powers, including the power to tax, against that person; and second, the Commerce Clause, where the Supreme Court held in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), that if the Congress does not act in an area then state tax may not be imposed upon a person unless there is “substantial nexus” with that person. Substantial nexus is more than minimum contacts, and *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), appears to stand for the proposition that some physical presence is needed to establish substantial nexus.

In Hawaii, section 237-22(a) HRS, states that there shall be excepted or deducted from the values, gross proceeds of sales, or gross income so much thereof as, under the Constitution and laws of the United States, the state is prohibited from taxing, but only so long as and only to the extent that the state is so prohibited. *In re Grayco Land Escrow, Ltd.*, 57 Haw. 436, 559 P.2d 264, *cert. denied*, 433 U.S. 910 (1977), established that Hawaii already extends its general excise and use taxes to reach the limit of the Constitution (“Thus, in plain and unmistakable language, the statute evidences the intention of the legislature to tax every form of business, subject to the taxing jurisdiction, not specifically exempted from its provisions.”). Given that background and case law, this bill is unnecessary. Nothing the legislature enacts will change the U.S. Constitution, and the bill can do no more than add confusion to the area. If the intent is for the legislature to encourage or require the department of taxation to go after entities fitting the fact patterns named in the bill, then there are other avenues, including the appropriation route, to motivate the department to do so.

## HB 1651 - Continued

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 requires the internet giant to begin collecting its sales taxes on purchases made by its residents.

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**LATE**  
Chamber of Commerce HAWAII  
*The Voice of Business*

**Testimony to the House Committee on Judiciary  
Tuesday, February 11, 2014 at 2:00 P.M.  
Conference Room 325, State Capitol**

**RE: HOUSE BILL 1651 RELATING TO TAXATION**

Chair Rhaods, Vice Chair Har, and Members of the Committee:

The Chamber of Commerce of Hawaii ("The Chamber") **supports** HB 1651 Relating to Taxation.

The Chamber is the largest business organization in Hawaii, representing over 1,000 businesses. Approximately 80% of our members are small businesses with less than 20 employees. As the "Voice of Business" in Hawaii, the organization works on behalf of members and the entire business community to improve the state's economic climate and to foster positive action on issues of common concern.

Currently, many internet-based sellers unfairly benefit from the State's inability to enforce the Use Tax against individual purchasers. The result is often lost revenue by the State, and lost sales by conventional and "brick and mortar" retailers, many of which provide employment opportunities for our residents. The bill would help eliminate this tax gap. We believe that measures such as these, which improve the enforceability of existing tax laws, are far preferable to new and higher taxes as the means of meeting the State's budgetary requirements.

Thank you for the opportunity to testify.