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**HOUSE COMMITTEE ON FINANCE
TESTIMONY REGARDING HB 1586
RELATING TO TAXATION**

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: FEBRUARY 26, 2009

TIME: 10AM

ROOM: 308

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

The House Committee on Economic Revitalization, Business & Military Affairs passed this measure unamended.

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 DEVELOPMENTS 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.

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 potential 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.



HAWAII GOVERNMENT EMPLOYEES ASSOCIATION
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The Twenty-Fifth Legislature, State of Hawaii
Hawaii State House of Representatives
Committee on Finance

Testimony by
Hawaii Government Employees Association
February 26, 2009

H.B. 1586 – RELATING
TO TAXATION

The Hawaii Government Employees Association supports the purpose and intent of H.B. 1586, which will allow the State of Hawaii to tax companies conducting business here but who are domiciled elsewhere if certain criteria are met. Essentially, it creates a nexus standard for taxing out-of-state businesses locally.

As our national economy has evolved, much more activity takes place through the Internet. There are several reasons for taxing Internet-based transactions. Retail trade has been transformed by the Internet. As the popularity of "e-commerce" grows, fairness dictates that Internet-based transactions should be treated in the same manner as other retail transactions. Retail transactions that are taxable by "bricks and mortar" retailers should also be taxable when sold through the Internet.

Hawaii has already lost millions of dollars in Internet-based sales, and the losses will likely increase as the importance of the Internet continues to grow. Therefore, we support H.B. 1586 in that it will aid in the collection of taxes. The ongoing loss of millions in tax revenue from e-commerce is a problem that will worsen over time unless we take appropriate action. The revenues gained through H.B. 1586 may be used to fund public education and other important public policy priorities.

Thank you for the opportunity to testify in support of this important measure.

Respectfully submitted,

Nora A. Nomura
Deputy Executive Director

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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 on 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.

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Alison Powers
Executive Director

TESTIMONY OF ALISON POWERS

HOUSE COMMITTEE ON FINANCE
Representative Marcus R. Oshiro, Chair
Representative Marilyn B. Lee, Vice Chair

Thursday, February 26, 2009
10:00 a.m.

HB 1586

Chair Oshiro, Vice Chair Lee and members of the Committee, my name is Alison Powers, Executive Director of Hawaii Insurers Council. Hawaii Insurers Council is a non-profit trade association of property and casualty insurance companies licensed to do business in Hawaii. Member companies underwrite approximately 60% of all property and casualty insurance premiums in the state.

Hawaii Insurers Council **opposes** H.B. 1586. The bill is very broad and creates a new tax code section to tax certain out of state businesses. The type of tax is undefined, the amount is undefined, and the impact on property casualty insurers is unclear.

All of Hawaii Insurers Council member insurers are licensed to do business in Hawaii, and therefore, subject to a premium tax under Chapter 431, HRS, which is in lieu of all other taxes. We ask that you hold this bill or exempt insurers licensed under Chapter 431, HRS.

Thank you for this opportunity to testify.