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To: The Honorable Gilbert S.C. Keith-Agaran, Chair
and Members of the Senate Committee on Judiciary and Labor

Date: Friday, March 20, 2015
Time: 9:15 A.M.
Place: Conference Room 016, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.B. 968, H.D. 2, Relating to Liability for Amounts Passed on as Tax

The Department of Taxation (Department) strongly supports H.B. 968, H.D. 2, an Administration measure, and provides the following information and comments for your consideration.

Summary of H.B. 968, H.D. 2

H.B. 968, H.D. 2 creates a conclusive presumption that a taxpayer is liable for any amounts passed on as a tax under title 14 of the Hawaii Revised Statutes (HRS), where said amount is separately stated in a receipt, contract, invoice, or bill. The amount of liability, however, is reduced by any amount the taxpayer returns to the source from which it was collected. This bill also authorizes the Department to adopt rules stating the maximum rates at which taxes may be passed on and imposes a civil penalty of up to $500 on businesses that pass on a tax at a rate higher than the maximum rate allowed. Finally, this bill requires the Department to notify the Department of Commerce and Consumer Affairs (DCCA) of judicial appeals in which a taxpayer has passed on a tax and has failed to remit the amount to the State or has been assessed a penalty for passing on a tax at a rate higher than the maximum allowed. This bill has a defective effective date of July 1, 2030.

H.B. 968, H.D. 2 Will Prevent Businesses from Keeping Amounts Passed on as Tax

The Department has found that taxpayers often visibly pass on title 14 taxes, such as the general excise tax (GET) and the transient accommodations tax (TAT), but do not remit these amounts to the State. These taxpayers often claim that they either do not owe the State any tax for the transaction or that they owe a lesser amount than what was actually collected.

Hawaii tax law is silent on the issue of passing on taxes such as the GET and TAT. The restriction on the amount of tax passed on is based in consumer protection law. For example, where the amount visibly passed on is represented as GET, the business cannot pass on an amount which exceeds the actual GET due on the gross income from that transaction. To do so would be a misrepresentation of the facts and a violation of consumer protection laws which the DCCA's Office of Consumer Protection monitors.

H.B. 968, H.D. 2 will assist the Department administratively with assessments and collections and will expedite the resolution of tax disputes. Taxpayers will not be able to take the contradictory position that they do not owe tax under title 14, HRS, even though they passed on and collected the tax from a third party. In addition, the public will benefit from this bill, as they will have greater certainty that any amount paid for a purported tax will be remitted to the State and not retained by the taxpayer.

It is important to note that adoption of this measure will not provide a windfall for the State, as H.B. 968, H.D. 2 does not impose any liability above the amount the taxpayer actually passed on and collected, and expressly excludes from liability amounts the taxpayer collected but then returned to third parties.

H.B. 968, H.D. 2 Will Clarify the Permissible Rates That May be Passed On as Tax

This measure will also provide clarity for taxpayers and consumers by allowing the Department to set forth by administrative rule the maximum rate at which a Hawaii tax may be passed on. The Department regularly receives questions from taxpayers and consumers regarding the permissible rate of GET and/or TAT that may be passed on.

Much of the uncertainty arises from the fact that amounts visibly passed on as GET are also subject to GET. As a result, a business may pass on GET at a rate higher than the statutory rate to make up for the difference.

For example, suppose that a taxpayer sells an item for $100 and is subject to GET at 4%. Further, suppose that the taxpayer passes on the GET at 4%, thereby collecting a total of $104 from the customer. Although the taxpayer collected $104, the taxpayer owes the State $4.16 (4% of $104), which is more than the $4 collected for tax. To make up for this difference, taxpayers are allowed to pass on GET at a rate 4.166% without violating consumer protection laws.

Unlike GET, which is imposed on gross income or proceeds, including amounts that were visibly passed on as GET, TAT is not imposed on amounts that were visibly passed on as GET or TAT. Accordingly, a business may only pass on TAT at the statutory rate.

For example, suppose that a taxpayer charges $100 for furnishing a hotel room and is subject to GET at 4% and TAT at 9.25%. The taxpayer may pass on $4.16 for GET (4.166% of $100), but may only pass on $9.25 for TAT (9.25% of $100). This illustrates the point that amounts passed on as GET are subject to GET, but amounts passed on as TAT are not subject to GET.

This bill will clear up any confusion regarding what rates may be passed on as Hawaii tax. Taxpayers who charge customers more than the maximum rates (e.g. charging a customer 5% instead of 4.166% for GET) will be subject to a civil penalty not to exceed $500, similar to the civil penalties imposed for other violations of the tax laws, such as failure to file or failure to pay taxes.

Proposed Amendments

During the hearing before the House Committee on Finance, it was pointed out that the current draft of H.B. 968 does not account for reductions in tax liability due to deductions or income splitting. It was also pointed out that the current draft does not account for differences between the amount passed on and the amount actually owed to the Department due to rounding.

To address these issues, the Department suggests that subsection (b) be amended to read:

(b) The following additional rules shall apply to this section:

(1) Any liability under subsection (a) shall be reduced by:

(A) the amount passed on as tax that the taxpayer has returned to the source from which it was collected;
(B) the amount passed on as tax that the taxpayer collected solely through rounding the correct amount of tax upward to the nearest cent;
(C) the amount of tax due on any amount properly deducted;
(D) the amount passed on as tax on any portion of receipts properly remitted to another taxpayer under an income splitting provision under title 14; and
(E) any amount authorized by the Department through administrative rule.

(2) All adjustments under subsection (b)(1) shall be made independently for each chapter under title 14.

(3) The adjustments allowed under this subsection shall not reduce the liability under subsection (a) to an amount that is lower than the actual amount of tax due, calculated without regard to this section.

The State of Alabama has addressed the rounding issue that was raised in the previous Committee by expressly stating that the additional amounts collected solely due to rounding must not be remitted to Alabama. The proposed amendment above takes this same approach and allows any liability under this measure to be reduced by excess amounts collected solely due to rounding. Alabama Code section 40-23-26 states:

> "In the event that any sum is collected from a consumer that purports to be collected because of this section, whether or not the amount is actually provided for hereunder, then any such sum, except such as is collected solely because of rounding the correct amount of tax upward to the nearest cent, shall be paid to the Department of Revenue for the purposes provided in § 40-23-35."

Finally, on the subject of rounding, the Department wishes to point out that in reality, situations in which the amount of tax passed on is rounded down to the nearest cent occurs as frequently as situations in which the amount is rounded up. Therefore, in reality, the effect of rounding on a taxpayer's liability will not be as drastic as suggested by overly simplistic examples. The example below, while simplistic, illustrates the cumulative effect of rounding and shows that the amount of tax passed on will closely approximate the amount of tax calculated under 237-13, HRS, regardless of rounding:

Example: A business on Oahu does 100,000 sales transactions. Suppose the sales consist of 40,000 sales at $1 each, 30,000 sales at $2 each, and 30,000 sales at $3 each. Using the GET pass on rate of 4.712%, the total amount passed on is $8,900 ($.05 on each of the 40,000 $1 sales, $.09 on each of the 30,000 $2 dollar sales and $.14 on each of the 30,000 $3 sales). Under H.B. 968, H.D. 2, the taxpayer is presumed liable for $8,900 in GET. The gross receipts for purposes of calculating the tax under section 237-13, HRS, equal $198,900 and the GET is $8,950.50. In this example, the presumptive liability under H.B. 968, H.D. 2 is $50.50 less than the amount due under section 237-13, HRS, on total receipts of nearly $200,000. This example shows that the concern over rounding is not as serious as represented by some opponents.

Defective Effective Date

The House Committee on Finance inserted a defective effective date of July 1, 2030 to further the conversation regarding the issues discussed above. Because the Department's proposed amendments address these issues, the Department respectfully requests that the effective date be changed to January 1, 2016. This will allow the Department time to issue administrative rules and provide guidance on this measure.

Conclusion

In summary, H.B. 968, H.D. 2 would amend the law to require taxpayers to remit the amounts visibly passed on and actually collected as Hawaii taxes. Taxpayers would not be required to remit any amounts returned to customers or any amounts in excess of what is owed under current law. H.B. 968, H.D. 2 would also authorize the Department to adopt rules setting forth the maximum rates at which taxes may be passed on and impose civil penalties for violating said rates.

Thank you for the opportunity to provide testimony in support of this measure.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: ADMINISTRATION, Liability for amounts passed on as tax

BILL NUMBER: HB 968, HD-2

INTRODUCED BY: House Committee on Finance

EXECUTIVE SUMMARY: The department of taxation has consistently, since 1957, taken a hands-off position regarding amounts passed on to consumers as tax, saying it is a consumer protection issue rather than a tax issue. This bill creates a conclusive presumption that the taxpayer is liable to the state for any such amounts collected as a recovery of the taxpayer's liability. This may create unintended problems, and we have provided some fact patterns to consider.

BRIEF SUMMARY: Adds a new section to HRS chapter 231 to provide that if an amount is charged as the tax owed by the taxpayer for the transaction and is separately stated in a receipt, contract, invoice, billing, or other evidence of the business activity, that taxpayer is conclusively liable for any amounts charged. States that the taxpayer is also liable for any amounts added as penalties and interest under HRS section 231-39. The taxpayer's liability shall be reduced by any amount collected as a recovery of the taxpayer's liability.

EFFECTIVE DATE: July 1, 2030

STAFF COMMENTS: This is an administration measure submitted by the department of taxation TAX-08 (15). It appears that the department is bothered by some taxpayers who visibly pass on a tax, such as the general excise tax or transient accommodations tax, and then fail to remit those monies to the department. As justification for the measure, the department states: "The public will benefit from this new provision because there will be certainty that any amount paid as tax will be remitted to the State and not retained by the taxpayer," and "The Department will have an easier time with assessment and collection in cases where any title 14 tax is passed on."

This measure, as proposed, has the potential to cause many more problems than it is intended to solve, and cannot be justified.

Consistently, since 1957, the department has always maintained in General Excise Tax Memorandum No. 4, that the "pass on" of tax is purely a matter of contract between the buyer and the seller. Current tax laws really don't care what is represented to the buyer by the seller, only that any amount paid between them becomes income to the seller and is then subject to tax as provided by law. This bill appears to make the taxing law irrelevant: if the seller states that a certain amount is tax and the buyer pays it, then the department is entitled to assess and collect that amount regardless of any other law. What if the seller made a mistake and applied either an incorrect rate or forgot to take advantage of an exemption that is allowed by law? Under current law, the seller is entitled to pay the department no more than the correct amount of tax, and then the seller must make peace with the buyer or suffer

consequences under the consumer protection law. (See discussion in Tax Facts 96-1.) Under this bill, the correct amount of tax is irrelevant. Assuming that the taxpayer can't prove that the difference has been refunded to the proper customer, the department just keeps the money. It's a "heads I win, tails you lose" situation.

Consider the following situations:

Contractor C is hired to do a renovation for a taxpayer, and the contract price is $10,000. C subcontracts part of the work to S for $4,000 including tax. C charges the owner $10,000 + 4.166% = $10,416. The owner pays that amount. Under current law, C is liable for tax on 4% of the gross price less the subcontract deduction, or 4% of $6,416 = $256. S is liable for tax on 4% of the $4,000 = $160. Under the bill, C must pay $416 tax and S must still pay the $160.

Tour operator T offers a package tour to tourists for $100, which includes payments to bus company B for $20, attraction A for $30, and hotel H for $45. T charges the tourist $104.16, and the tourist pays it. Under current law, T is liable for tax at 4% of what T keeps, namely 4% of $9.16 or about 37 cents. B, A, and H are liable for tax at 4% of what they respectively keep. Under the bill, T must pay $4.16 and B, A, and H must still pay 4% of the $95 they get between them.

Is this really what is intended? If not, the bill needs to be fixed or scrapped.

Digested 3/19/15

Chamber of Commerce HAWAII
The Voice of Business

Testimony to the Senate Committee on Judiciary and Labor
Friday, March 20, 2015 at 9:15 A.M.
Conference Room 016, State Capitol

RE: HOUSE BILL 968 HD2 RELATING TO LIABILITY FOR AMOUNTS PASSED ON AS TAX

Chair Keith-Agaran, Vice Chair Shimabukuro, and Members of the Committee:

The Chamber of Commerce Hawaii ("The Chamber") would like to **express serious concerns** on HB 968 HD2, which creates conclusive presumption that taxpayer is liable for any amounts passed on to consumers as payment for any tax authorized by title 14, Hawaii Revised Statutes, unless the taxpayer returns the overpayment to the consumer. Also provides for civil penalty and reporting of violations to the office of consumer protection.

The Chamber is Hawaii's leading statewide business advocacy organization, representing about 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.

We have serious concerns on this bill as it seems the bill creates presumptions where they might be factually inaccurate. Tax liability should turn on whether or not the taxpayer actually engaged in a taxable transaction.

We do understand a consumer protection problem if someone collects tax from a customer but doesn't remit the collected amounts to the taxing authority. Luckily, DOTAX has already stated that, to the extent you tell customers that you're collecting tax and don't actually pay it to the state, the matter will be referred to consumer protection enforcement folks.

Thank you for the opportunity to testify.

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HOUSE OF REPRESENTATIVES
THE TWENTY-EIGHTH LEGISLATURE
REGULAR SESSION OF 2015

COMMITTEE ON JUDICIARY AND LABOR
Testimony on H.B. 968 HD2
Hearing: March 20, 2015

(RELATING LIABILITY FOR AMOUNTS PASSED ON AS TAX)

Chair Keith-Agaran, Vice Chair Shimabukuro, and members of the Committee. My name is Peter Fritz. I am an attorney in private practice and a former Rules Specialist with the Department of Taxation ("DOTAX"). I am testifying **in opposition** to this bill because as currently drafted, it could impose liability for an amount greater than the amount of tax owed under the applicable statute in Title 14, denies due process to a taxpayer, could result in a decrease in tax receipts and undermine future actions against online sellers.

This bill creates a conclusive presumption that a taxpayer is liable for any amounts passed on to customers as payment for any tax under title 14, Hawaii Revised Statutes and requires DOTAX to adopt administrative rules stating the maximum rates at which taxes under Title 14 may be passed on.

Hawaii's General Excise Tax ("GET") is a tax that is imposed on the taxpayer under Title 14. The tax is imposed at a rate of 4% of total gross income for retail sales or 0.5% of total gross income for wholesale sales. There is also a county surcharge of .05% for gross receipts on retail sales on Oahu. A taxpayer is liable to pay the State pursuant to § 237-13 Hawaii Revised Statutes, ("HRS") and for the County Surcharge under Chapter 42, HRS. These statutes create an obligation between the state and the taxpayer.

According to General Excise Tax Memorandum No. 4:

> Whether there is a visible pass on or not, the Department of Taxation will look to the seller for the tax upon the seller's total gross receipts. **Any amount added as the tax and collected by the taxpayer must be considered as part of the price received, and will be a part of the gross receipts of the taxpayer and must be reported as taxable income.**

General Excise Tax Memorandum No. 4 also states that a "visible pass on of the GET is entirely a matter of contractual agreement between the buyer and the seller." There is privity of contract between the buyer and the seller. It is the buyer that can bring an action to recover the amount of the visible pass on. It is more likely than not that a buyer would have a superior claim to the DOTAX in a bankruptcy proceeding. Because the State is not a party to the contract.

Because the amount of tax is calculated as a percentage of a taxpayer's gross receipts and the visible pass on often results in an amount that has a fractional portion of a cent and requires rounding, whereas calculating the tax on the total gross receipts does not result in a fractional cent. Because of rounding, this bill could cause a taxpayer to be liable for an amount that is greater than the taxpayer's liability under the applicable section of the HRS.

I. DOTAX Cannot Access a Liability that Exceeds the Tax Owed Under the Applicable Tax Statute.

- **This Bill Creates a Liability That May be Greater Than the Tax Liability under § 237-13 HRS.** Businesses can add an amount onto an invoice to cover the amount of tax on a sale. Because any amount passed on to a customer is part of the gross receipts of a business and taxable, the tax rate is increased from 4.5% to 4.712% to cover the tax on the amount added to an invoice. This often necessitates rounding of the amount passed to the nearest whole $0.01. This bill creates a liability that could be greater than the tax imposed by the applicable tax statute because of the need to round to the nearest $0.01.
    - Example: A "Dollar Store" located on Oahu sells an item for $1.00 and adds an additional 4.712% of the purchase price to cover the general excise tax. This amounts to an additional $.04712. The store rounds up the purchase price to $1.05. If the store makes 100,000 sales at $1, it would pass on an additional $.05 per sale. The total amount passed on would be $5000.00.
        - The GET on the $105,000 of gross receipts would be 4.5% of this amount or $4725.00.
        - Under this bill, a taxpayer would be liable for $5,000.00 to DOTAX notwithstanding the fact that the taxpayer's tax liability under § 237-13, HRS and Chapter 42, HRS is only $4725.00. Because this bill creates a conclusive presumption, which is a presumption which cannot be overcome or changed by any additional evidence or argument, other than showing that an amount was repaid to the customer the taxpayer is liable for the $5,000.00. However, fractional cents cannot be returned to a customer.
        - How can a taxpayer be liable to the Department of Taxation for an amount in excess of the tax imposed under § 237-13, HRS?

II. Denial of Due Process to a Taxpayer

- This bill could deny due process to a Taxpayer.
    - This bill creates a conclusive presumption of liability. A conclusive presumption is a presumption of law that cannot be rebutted by evidence and must be taken to be the case whatever the evidence to the contrary. Courts have held conclusive presumptions to be unconstitutional; too unfair, and thus a denial of due process.
    - Example of due process denial of due process in a transaction that involves a change of classification of transaction from retail to wholesale. A business sells a product at $2.00. It adds $0.08 cents for GET for a total price of $2.08. The business subsequently determines that the sale was at wholesale and the tax on a

wholesale transaction is ($2.08*.005) or $.01. The business includes the $2.08 in its gross receipts and calculates the tax on its total gross receipts. If DOTAX does not change the classification from wholesale back to retail during an audit, the taxpayer paid the proper amount of tax required by Chapter 237, HRS.

- If the taxpayer paid the legal amount of tax required by law, how can DOTAX insist that the business is liable for an additional $0.07 (the difference between the $0.08 added for a retail sale and the tax of $0.01 for a wholesale sale)?
  - DOTAX does not have the authority to collect amounts other than the amount of tax owed. Title 14 does not contain any statute authorizing collection of non-tax amounts. Because this bill created a conclusive presumption, a taxpayer cannot argue it is not liable for this non tax amount, but DOTAX may not have any statute authorizing it to collect this amount.
- Denial of the Right to Assert Defenses to Repayment to a Customer. In the above example, assume that the customer owes money to the business. The business should be able to offset any claim by the customer for a refund of the $0.07 against the amount owed to the company. However, unless the taxpayer returns the amount to the customer, the taxpayer is liable to the State for the amount of $0.07. Because this bill creates a conclusive presumption that the taxpayer is liable for this amount unless repaid to the customer a taxpayer cannot avoid liability by claiming a right to offset the amount.

III. Potential to Reduce State Tax Receipts. Businesses could decide to avoid liability by ending a visible pass on of the tax. When a business visibly adds an amount to an invoice, that amount is part of the gross receipts of the business and is taxed. This increases the state's tax revenue. However, if a business decides to stop visibly passing on a tax, tax receipts would drop because there would be no GET from an amount added to the invoice.

If it is determined that DOTAX can promulgates rules that establish the maximum rate of the visible pass on of the GET that prohibits rounding up, companies may decide to eliminate the visible pass on. Elimination of the visible pass on would reduce the gross sales price which would reduce state tax receipts.

IV. Potential to Undermine Future Actions Against Businesses such as Online Travel Companies.

- Judge Chang, when rendering a decision in open court in the Online Travel Companies ("OTC") litigation, made it very clear that he was finding that the excise tax was far reaching and that the nonresident OTCs had GET liability. However, the decision might have been different if Hawaii had had a sales tax.
- Under the holding of Quill Corp. v. North Dakota, 504 U.S. 298 (1992) a state may only require a business to collect the state's sales tax if the business has a substantial nexus with the state. Because Hawaii has an excise tax, the holding of Quill may not apply.

- Changes to tax law that make it operate like a sales tax, such as imposing liability on the seller for the visible pass, could cause provide justification for a court to rule that the substantial nexus requirements of Quill apply and prevent Hawaii from prevailing in an action to collect a tax in future actions that are similar to the OTC litigation.

V. DOTAX Does not Have the Authority to Fine a Taxpayer for What may be a Deceptive Trade Practice

According to General Excise Tax Memorandum No. 4. [a]ny amount added as the tax and collected by the taxpayer must be considered as part of the price received, and will be a part of the gross receipts of the taxpayer and must be reported as taxable income. **In Tax Facts 98-1 the DOTAX said "[t]he general excise tax law does not limit the percentage which can be visibly passed on to customers . . . the law is silent on this issue, but consumer protection laws do"**

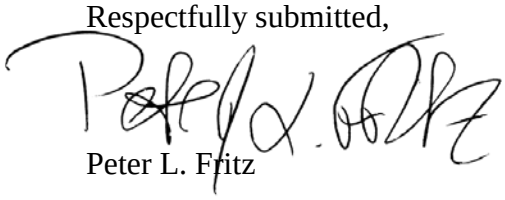
Hawaii Revised Statute § 237-13 generally imposes a tax on a taxpayer's gross receipts of 4.0% on retail sales. Since any amount visibly passed on is part of the price received, there is no prohibition in Title 14 that would prevent a taxpayer from adding 10% as a visible pass on as long as the amount of the visible pass on was included in the taxpayer's gross receipts. The full tax under § 237-13, HRS was paid.

Because nothing in Title 14 limits on the percentage which can be visibly passed on to customers, it is respectfully submitted that the DOTAX cannot draft rules limiting the maximum percentage that can be visibly passed on or impose a fine on a taxpayer for the amount added onto an invoice.

Regulation of the visible pass on belongs to the Office of Consumer Affairs which has the authority to enforce deceptive trade practices. If DOTAX's intent is alert the Office of Consumer protection and the customer to what may be a deceptive trade practice, this can be accomplished by changing the confidentiality provisions under Title 14.

Thank you for the opportunity to testify.

Respectfully submitted,



Peter L. Fritz

From: mailinglist@capitol.hawaii.gov
To: JDLTestimony
Cc:
Subject: Submitted testimony for HB968 on Mar 20, 2015 09:15AM
Date: Thursday, March 19, 2015 2:06:43 PM

HB968
Submitted on: 3/19/2015
Testimony for JDL on Mar 20, 2015 09:15AM in Conference Room 016

Submitted By	Organization	Testifier Position	Present at Hearing
Jessica Swanson	Individual	Oppose	No

Comments: This Bill will discourage taxpayers from itemizing GE tax. The GE tax is not a sale tax, it is assessed to the seller for the privilege of doing business in Hawaii. The seller is not required to show the amount visibly passed on. It also need to clarify that for cash basis taxpayer, if the invoice is issued but not paid, would the seller be liable for the amount not collected?

Please note that testimony submitted less than 24 hours prior to the hearing, improperly identified, or directed to the incorrect office, may not be posted online or distributed to the committee prior to the convening of the public hearing.

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