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To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Friday, March 31, 2017
Time: 2:00 P.M.
Place: Conference Room 308, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: S.B. 620, S.D. 2, H.D. 1, Relating to Taxation

The Department of Taxation (Department) appreciates the intent of S.B. 620, S.D. 2, H.D. 1, and provides the following comments for your consideration.

S.B. 620, S.D. 2, H.D. 1, amends the definition of business in the general excise tax (GET) to state that doing "business," for purposes of the GET, does not require a physical presence as long as the taxpayer has $100,000 or more of gross receipts attributable to Hawaii. The bill has a defective effective date of July 1, 2059.

The Department notes that this measure addresses the State law issue of whether a seller without physical presence in Hawaii is engaged in business, and therefore, subject to GET. A bright line test like Hawaii sales of $100,000 or more will clarify the State's position. However, amending Hawaii's law, as this bill proposes, would only remove the main challenge based on State law; this measure would not prevent a Commerce Clause (nexus) challenge under the United States Constitution.

The Hawaii Supreme Court has applied the nexus test from *Tyler Pipe Indus., Inc. v. Washington Dept. of Revenue*, 483 U.S. 232 (1987) when determining whether application of the GET statute violates the Commerce Clause. See *Tax Appeal of Baker & Taylor*, 82 P.3d 804 (2004). The *Tyler Pipe* test does not depend on physical presence, but instead turns on "whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in the state." Thus, under current Hawaii Supreme Court jurisprudence, the proposed $100,000 sales threshold may withstand a Commerce Clause (nexus) challenge despite the explicit exclusion of a physical presence requirement.

However, any taxpayer challenging the statute would attempt to apply *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992). In this case, the United States Supreme Court held that a seller must have a physical presence in a State to be subject to that State's sales and use tax collection requirements. This requirement of physical presence is rooted in the Commerce Clause of the United States Constitution and will not be affected by the amendment to State law proposed by this bill. If the rule from *Quill* is applied, any application of the GET to a taxpayer without a physical presence in the State will be in violation of the Commerce Clause.

Thus, if passed and enforced, this measure will likely lead to litigation, and may not lead to additional revenue for the State, because affected taxpayers may still obtain relief under the Commerce Clause of the United States Constitution.

Thank you for the opportunity to provide comments.

**TESTIMONY OF**
**THE DEPARTMENT OF THE ATTORNEY GENERAL**
**TWENTY-NINTH LEGISLATURE, 2017**

**ON THE FOLLOWING MEASURE:**
S.B. NO. 620, S.D. 2, H.D. 1, RELATING TO TAXATION.

**BEFORE THE:**
HOUSE COMMITTEE ON FINANCE

**DATE:** Friday, March 31, 2017 **TIME:** 2:00 p.m.

**LOCATION:** State Capitol, Room 308

**TESTIFIER(S):** Douglas S. Chin, Attorney General, or
Stacie M. Nakamura, Deputy Attorney General

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Chair Luke and Members of the Committee:

The Department of the Attorney General has concerns about this bill because it might be subject to challenge as violating the Commerce Clause of the United States Constitution.

The purpose of this bill is to amend the definition of "business" in chapter 237, Hawaii Revised Statutes (HRS), relating to the general excise tax. Under the proposed amendment, a taxpayer would be engaging in "business," and therefore subject to the general excise tax, regardless of whether it has a physical presence in Hawaii. The bill also clarifies that a person with no physical presence in the Hawaii is engaged in "business" in the State if the person's gross receipts attributable to Hawaii is $100,000 or more.

The amendments proposed in this bill might withstand a challenge in the state court under current Hawaii Supreme Court jurisprudence, but the amendments may still be subject to constitutional challenge.

The Commerce Clause of United States Constitution explicitly grants power to Congress to regulate interstate commerce, and in doing so, also implicitly restricts states from enacting laws that unduly burden interstate commerce. The United States Supreme Court stated that a state tax will survive a Commerce Clause challenge if the tax "is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977). Furthermore, the United States Supreme Court in Quill Corp. v. North Dakota, 504 U.S. 298 (1992), appears to affirm the need for some type of physical presence, as originally established in National Bellas Hess, Inc. v. Department of Revenue of Illinois, 386 U.S. 753 (1967), in order to meet the substantial nexus requirement.

Today's proliferation of online commerce reveals that the physical presence requirement affirmed by Quill 25 years ago may be inadequate in today's market. For example, New York's highest court recently said that "[t]he world has changed dramatically in the last two decades, and it may be that the physical presence test is outdated." Overstock.com, Inc. v. New York Department of Taxation and Finance, 20 N.Y.3d 586, 595 (2013). Despite this statement, the New York court maintained that the taxpayer must have some type of physical presence in the state.

It may be important to note that some of the authoritative cases, including Quill, interpret the substantial nexus requirement to involve a state sales and use tax, not a general excise tax, which is at issue here in Hawaii. When describing the Hawaii general excise tax, the Hawaii Supreme Court stated "our case law does not support the contention that the taxpayer must have a physical presence in the state." Travelocity.com, L.P. v. Director of Taxation, 135 Hawaii 88 (2015). It is an open question as to whether the tests under Quill will be applied to a general excise tax and whether the general excise tax that does not require a physical presence in the state would ultimately be sustained under a Commerce Clause challenge.

Because the main purpose of this bill is to apply the state general excise tax to the activity of certain taxpayers with no physical presence in Hawaii, if this bill becomes law, a taxpayer may cite to the United States Supreme Court decisions of Quill and Bellas Hess to challenge the State that the application of the general excise tax to a taxpayer with no physical presence in Hawaii violates the Commerce Clause of the United States Constitution.

Thank you for the opportunity to provide comments.

SUBJECT: GENERAL EXCISE, Define Doing Business Without Physical Presence

BILL NUMBER: SB 620, HD-1

INTRODUCED BY: House Committee on Consumer Protection and Commerce

EXECUTIVE SUMMARY: This measure is an attempt to adopt a form of "economic nexus" or "factor presence nexus," namely a statement that substantial sales in a state give rise to a sufficient connection between the state and the seller to enable that state to impose sales tax or use tax collection obligations. While the measure may be subject to constitutional challenge, it is in line with other states' measures increasing pressure on remote sellers to collect and remit sales and use taxes owed on purchases by customers in the state.

SYNOPSIS: Amends the definition of "business" or "engaging" in business in HRS section 237-2 to provide that a person with no physical presence in the State is engaged in "business" in this State if the person has gross receipts attributable to this State of $100,000 or more.

EFFECTIVE DATE: July 1, 2059.

STAFF COMMENTS: The United States Constitution has been interpreted as providing two limits on the states' powers to tax. These limits come from: 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 otherwise define the threshold for taxability, 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.").

This bill is, of course, trying to solve the problem, faced by all states that have enacted sales and use taxes, about collecting sales and use taxes on remote sellers. A seller with no physical presence in a customer's state might see no obligation to collect and remit tax in the customer's state. The customer would be liable for use tax, but tax departments throughout the country have met with little success in motivating such customers, especially those with small purchases, to pay use tax.

Nothing the legislature enacts will change the U.S. Constitution, and the bill may face constitutional challenge if enacted. Even so, the Multistate Tax Commission has recommended, and many states have enacted, economic nexus or factor presence nexus standards saying that nexus should be found when a taxpayer has a significant dollar amount of sales activity in the state irrespective of physical presence. These standards have motivated some of the larger remote sellers to agree to collect and remit sales and use taxes on that activity.

Specifically, it was recently announced that Amazon, the online retailer, will be collecting and remitting Hawaii tax on online purchases effective April 1, 2017. If proposed legislation such as this is motivating online sellers to come to the table, the legislation may well be having its desired effect.

Digested 3/29/2017

Chamber of Commerce HAWAII
The Voice of Business

# Testimony to the House Committee on Finance
# Friday, March 31, 2017 at 2:00 P.M.
# Conference Room 211, State Capitol

## RE: SENATE BILL 620 SD2 HD1 RELATING TO TAXATION

Chair Luke, Vice Chair Cullen, and Members of the Committee:

The Chamber of Commerce Hawaii ("The Chamber") **supports** SB 620 SD2 HD1, which amends the definition of "business" in the State's general excise tax law.

The Chamber is Hawaii's leading statewide business advocacy organization, representing about 1,600+ 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 retailers and vendors 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. This bill amends the definition of "business" in the State's general excise tax law and could help eliminate this tax gap. We believe that measures such as these provide fairness and equity for all businesses.

Thank you for the opportunity to testify.

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**TESTIMONY OF TINA YAMAKI**
**PRESIDENT**
**RETAIL MERCHANTS OF HAWAII**
**March 31, 2017**

## Re: SB 620 SD 2 HD1 Relating to Taxation

Good afternoon Chair Luke and members of the Committee on Finance. I am Tina Yamaki, President of the Retail Merchants of Hawaii and I appreciate this opportunity to testify.

The Retail Merchants of Hawaii (RMH) is a statewide 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. The retail industry is one of the largest employers in the state, employing 25% of the labor force.

The Retail Merchants of Hawaii supports SB 620 SD2 HD1 Relating to Taxation. Our local brick and mortar stores are the economic backbones of our communities that provide employment and tax revenue to fund vital services throughout the State. Many of our retailers statewide are already operating on a thin margin, especially mom and pop stores. This measure would provide e-fairness by leveling the playing field for businesses in our community.

Currently under the existing state law, consumers are required to pay the General Excise Tax on the goods they purchase in stores physically located in the state of Hawaii. However, if they shop on line, sellers are not required to collect a tax in the same way our local businesses do. This puts our local retailers at a disadvantage as this effectively makes products purchased at brick-and-mortar stores more expensive than products purchased online.

In 2012, the National Conference of State Legislators did a study on E-Fairness conducted by the University of Tennessee. The study indicated that Hawaii's uncollected use tax from remote sales equaled to $60,000,000 in Electronic Business to Business and Business to Customer. Every year since then online business has been increasing substantially.

The news that Amazon will begin charging tax on Hawaii purchases is a step in the right direction. However there are so many more online retailers like Overstock, Kohls, QVC, Wayfair, HSN to name a few that are not collecting taxes.

We urge you to support SB 620 SD2 HD1 and have the state of Hawaii join the 45 other states that have enacted similar e-fairness legislation.

Again mahalo for this opportunity to testify.

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HOUSE OF REPRESENTATIVES
THE TWENTY-NINTH LEGISLATURE
REGULAR SESSION OF 2017

COMMITTEE ON FINANCE
Testimony on S.B. 620 SD2 HD1
Hearing: March 31, 2017
Relating To Taxation

Chair Luke, Vice Chair Cullen and members of the Committee. My name is Peter Fritz. I am a former Rules Specialist with the Department of Taxation, and attorney that has been involved in drafting bills relating to taxation of Internet purchases for this and previous legislative sessions. I am testifying in **strong support** of S.B. 620 SD2.

The estimate for lost taxes for Internet purchases for companies that do not pay Hawaii's General Excise Tax ("GET") is $15 million. It has been reported that Amazon will voluntarily begin paying GET on goods shipped to Hawaii customers beginning in April; however, because Amazon is responsible for approximately 50% of all Internet sales Amazon's agreement may result in additional revenues of approximately $7.5 million, not $15 million.

For Hawaii to collect the $7.5 million that may be owed by other companies, Hawaii needs to enact a law establishing a basis for taxing these companies. Courts have held that companies that do substantial business in a state, can be held to have an economic nexus with that state and this bill is similar to those decisions. Without such a law, companies may take the position that they can refuse to pay taxes on the sale to Hawaii consumers.

I respectfully request that this Committee move this bill.

Thank you for the opportunity to testify.

Respectfully submitted,

Peter L. Fritz