TAX FOUNDATION
OF HAWAII

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November 15, 2017

Rules Office
Hawaii Department of Taxation
830 Punchbowl Street, Room 221
Honolulu, HI 96813

Re: **Comments on Proposed Rules Relating to Exported Services**

Ladies and Gentlemen:

The Foundation is strongly in support of the Department's efforts to add clarity to the sourcing of services and commissions for Hawaii General Excise Tax ("GET") purposes. We do have some substantive comments on this draft.

A. The Substantive Treatment of Cancellation Fees Is Questionable.

Section 18-237-29.53-12: The rule as presented makes no attempt to create any sourcing rule for cancellation fees. It suggests that the Department would seek to tax cancellation fees regardless of whether the services were performed in Hawaii or whether the services, if performed, would have been consumed in Hawaii. Such a rule is not internally consistent and would fail *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

In re Keehn, No. 3045 (Haw. Tax App. Ct. Jan. 10, 1994), discussed in TIR 95-1, held that income from a covenant not to compete is compensation for lost earnings and was thus compensation for personal services. Cancellation charges are also compensation for lost earnings and logically would follow the same rule. Thus, we suggest that the normal rule applicable to services would apply, and in the example given, the services are properly sourced outside of Hawaii because the consumer would be ABC Company under section 18-237-29.53-11(a)(2) and (b) Example 2, so the result in the example as presented would not be correct.

B. The Commission Agent Rule's "Online Exception" Is Questionable.

Section 18-237-29.53-10: The commission agent rule states that services by a commission agent are sourced to the location of the commission agent, except where the transaction is consummated "online," defined to be "exclusively through a website or web application without any in-person contact." We are concerned that this "online exception" is not administrable and may not be supportable.

First, this "online exception" is difficult or impossible to administer. Does it still apply, for example, if the customer was using the website and fully intended to buy something, but ran into difficulty and either picked up the phone or availed herself of online chat help? If the phone call or chat help voids the exception, how does either a taxpayer or the Department figure out whether that happened?

Second, there appears to be no support in the statutes for the proposed online exception. If the exception is an attempt to segregate a business with service aspects from one with none, *see* HRS § 237-7, "no human contact" as a standard is not supported by the case law. *In re Photo Management, Inc.*, 63 Haw. 579, 633 P.2d 535 (1981), held that a business where customers had contact with the seller's employees, but the latter were not highly skilled, was not a service business but a manufacturing business.

For these reasons, we do not support the "online exception" and we suggest that it be eliminated. Rather, the Department may believe it appropriate to reclassify a business with no service elements to another taxable category, such as Manufacturing or All Other (royalties). That approach might be accomplished by a construct such as:

> (a) Except as provided in section 18-237-29.53-04, services performed by a commissioned agent are used or consumed where the agent is located at the time the agent's services are performed.
>
> (b) Activities where the commissioned agent provides no services, such as where the transaction occurs exclusively through a website or web application without any in-person contact, may result in classification of the activities in a taxable classification other than "Services Including Professional" under HRS section 237-13(6) or "Commissions" under HRS section 237-13(5). The exemption in HRS section 237-29.53, as explained in these rules, only applies to income classified under HRS section 237-13(5) or (6).

We also urge the Department to act on our other comments contained in our letter of October 6, 2017, a copy of which is attached for ease of reference, to the extent not already acted upon.

Thank you for the opportunity to submit comments.

Very truly yours,

Thomas Yamachika

Thomas Yamachika
President

Enclosure

TAX FOUNDATION
OF HAWAII

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COPY

October 6, 2017

Rules Office
Hawaii Department of Taxation
830 Punchbowl Street, Room 221
Honolulu, HI 96813

Re: **Comments on Proposed Rules Relating to Exported Services**

Ladies and Gentlemen:

The Foundation is strongly in support of the Department's efforts to add clarity to the sourcing of services and commissions for Hawaii General Excise Tax ("GET") purposes.

A. Some Rules Need to be Classified Under Other Statutory Sections, Or At Least Cross-Referenced.

The proposed rules relating to exported services represent a clear and thoughtful attempt to unravel some of the issues that have been plaguing tax practitioners and the Department for years. Trying to tackle these disparate issues under one statutory section, however, may be problematic because practitioners, especially those normally practicing in other jurisdictions, need to be able to locate the proper rules in a quick and logical manner and probably would not intuitively look under this section.

1. Commission Agent.

Rules defining a "commission agent" are sorely needed. The definition of the term in proposed § 18-237-29.53-01 and Examples 1 and 2 thereunder represent a common-sense approach to the issue, but may be difficult for practitioners to locate because they do not immediately relate to exported services. We suggest that these rules be classified under a different statutory section, such as HRS § 237-13(5) (imposing tax on commission activity).

If the Department is not open to renumbering or reclassifying the rules, we strongly urge that an appropriate cross-reference be added under section 237-13(5) such as:

§ 18-237-13-04 [~~to 05~~] (Reserved.)

§ 18-237-13-05 Tax upon commissions. For rules defining a "commissioned agent" subject to HRS section 237-13(5), see section 18-237-29.53-01. [Eff] (Auth: HRS §231-3(9), 237-8) (Imp: HRS §237-13(5))

2. Noncommissioned Negotiated Contract Rate.

Rules defining a "noncommissioned negotiated contract rate" in proposed § 18-237-29.53-01 and Examples 3-5 thereunder, and the rules in § 18-237-29.53-06, also are useful and flow directly from *In re Travelocity.com, L.P.*, 135 Haw. 88, 346 P.3d 157 (Haw. 2015), but may be difficult for practitioners to locate. We suggest that these rules be classified under HRS § 237-18, which the Hawaii Supreme Court was construing in that decision.

If the Department is not open to renumbering or reclassifying the rules, we strongly urge that an appropriate cross-reference be added under section 237-18(g) such as:

[~~§ 18-237-17 to 19~~ ~~(Reserved.)~~]

§ 18-237-18-07 Transient accommodations furnished through arrangements made by a travel agency or tour packager. For rules defining "noncommissioned negotiated contract rates" for purposes of section 237-18(g), HRS, see sections 18-237-29.53-01 and 18-237-29.53-06. [Eff] (Auth: HRS §231-3(9), 237-8) (Imp: HRS §237-18)

B. The Substantive Treatment of Cancellation Fees Is Questionable.

Section 18-237-29.53-12: The rule as presented suggests that the Department would seek to tax cancellation fees regardless of whether the services were performed in Hawaii or whether the services, if performed, would have been consumed in Hawaii. Such a rule is not internally consistent and would fail *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). We recommend that the Department instead adopt a rule stating that cancellation charges are considered service fees and are sourced according to the rules applicable to services. In the example given, we suggest that the services are properly sourced outside of Hawaii because the consumer would be ABC Company under section 18-237-29.53-11(a)(2) and (b) Example 2.

C. The Concept of "Bad Faith" Is Undefined.

Section 18-237-29.53-02(a): The standard begins with "Absent bad faith," but there is no attempt to define what bad faith is or what consequences ensue if it is present. This language, furthermore, appears nowhere else in the proposed rules. We recommend that this language be deleted to prevent confusion. Actual bad faith or fraud can be dealt with under other statutes or case law.

D. Stylistic Comments.

Section 18-237-29.53-03: The first sentence does not seem to be grammatically correct. We suggest, "Contracting is used or consumed where the real property to which the contracting activity pertains is located." This would account for activity taking place in a different location from the project, such as under the fact pattern in Example 1.

Examples Cross-Referencing the Same Section: Several examples cross-reference the same section in which they are located. For example, section 18-237-29.53-07 Example 4 ends, "Because the complaint was not filed, section 18-237-29.53-07 does not apply. Instead, section 18-237-29.53-11 will apply." To be consistent with the Hawaii Administrative Rules Drafting Manual (2006) at page 65, we suggest, "Because the complaint was not filed, this section does not apply…." This comment also applies to section 18-237-29.53-09 Example 4. In addition, references to a different subdivision in the same section need not state the section number in full. For example, section 18-237-29.53-11(b) Example 1 ends with "pursuant to section 18-237-29.53-11(a)(3)," where it should say "pursuant to subsection (a)(3)." The same comment applies to the other examples in section 18-237-29.53-11.

Section 237-29.53-11(b) Example 5: The example as presented is confusing because the referenced rule, subsection (a)(3), states that if the customer is an individual, the service is used or consumed where the individual resides, but the example shows two places of residence. Language should be added clarifying when the test is applied, such as:

> Arnold Accountant, an accountant located in Hawaii, is hired by Mary Mover, a California resident, to prepare her *2016* federal and state tax returns. Mary Mover must file state tax returns in California, where she resided for the first half of *2016*, and Hawaii, where she currently resides. *Arnold Accountant performs his services in 2017, when Mary Mover is a resident of Hawaii. Thus,* all of the value or gross income that Arnold Accountant receives from Mary Mover is not exempt under section 237-29.53, HRS, because Arnold Accountant's services are used or consumed in Hawaii, where Mary Mover resides, pursuant to *subsection (a)(3).*

Thank you for the opportunity to submit comments.

Very truly yours,

Thomas Yamachika
President