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July 10, 2012

LETTER RULING 2012-10

[Redacted Text]

Attn: [Redacted Text]

[Redacted Text]

[Redacted Text]

Re: General Excise Tax Nexus of Internet Seller

Dear [Redacted Text]:

By letter dated December 1, 2011, [Redacted Text] (the "Taxpayer") requested the State of Hawaii Department of Taxation ("Department") rule whether Taxpayer has nexus with the State and must pay General Excise Tax ("GET") on its gross income from internet sales transactions.

QUESTIONS PRESENTED

1. Whether Taxpayer's gross receipts from internet sales to consumers whose place of delivery is in the state of Hawaii are subject to General Excise Tax due to the implementation of a mutual merchandise return policy program and a loyalty points program involving an affiliated company with physical retail stores in the state of Hawaii.
2. Whether the Honolulu County GET surcharge of 0.500% will apply to internet sales transactions between the Taxpayer and consumers whose place of delivery is located in Honolulu County.
3. How Taxpayer can comply with the applicable Hawaii GET laws and rules.

SHORT ANSWERS

1. Taxpayer's gross receipts from internet sales transactions with consumers whose place of delivery is in the state of Hawaii are subject to the GET because Taxpayer has nexus with the State through the physical presence of an affiliate/representative ("Affiliate") who is participating in a mutual merchandise return and loyalty points program with and on behalf of the Taxpayer.
2. Gross receipts from sales transactions with consumers whose place of delivery is located in Honolulu County are subject to the 0.500% GET surcharge. The Taxpayer has nexus with Honolulu County because Affiliate is acting as the Taxpayer's agent and has at least one

retail store location in the County.

3. Taxpayer must obtain a GET license and file periodic and annual GET returns with the Department. The required reporting frequency of the periodic return depends on the amount of GET the Taxpayer expects to owe during the period. Periodic and annual GET returns must be filed even when there are no gross receipts to report.

FACTS REPRESENTED BY THE TAXPAYER

Taxpayer is an internet retailer of fragrances and other specialty items. Taxpayer is incorporated in the state of [Redacted Text] and currently operates its business out of [Redacted Text]. Taxpayer does not have a physical presence, employee(s), payroll, or solicitor(s) in the state of Hawaii. Neither does Taxpayer own or lease any real or tangible personal property in the state of Hawaii.

Taxpayer's parent company, [Redacted Text] (the "Parent Company") and Taxpayer's affiliate company, [Redacted Text] ("Affiliate") are based in [Redacted Text]. Affiliate has physical retail store locations throughout the United States and as of December 1, 2011 there were eight Affiliate retail stores in the state of Hawaii.

The corporate headquarters and the only warehouse/distribution center for Taxpayer, Parent Company, and Affiliate are also physically located in [Redacted Text]. All shipments from this centralized warehouse for internet sales and to Affiliate's retail stores are shipped through common carrier services.

On or about September 1, 2011 and not prior, both Taxpayer and Affiliate began promoting a loyalty points program whereby the customers of each company will receive points for purchases made either from the Taxpayer's internet site or Affiliate's retail store locations. As these points accrue, the customer reach a threshold where they will receive a fixed-price redeemable gift certificate to use interchangeably at either an Affiliate retail store location or at Taxpayer's internet website. Also, starting on or about September 1, 2011 customers of Taxpayer and Affiliate gained the option to return merchandise purchased on the Taxpayer's internet website to Affiliate retail store locations in addition to regular online returns.

LAW AND ANALYSIS

I. General Excise Tax Nexus

Section 237-13, Hawaii Revised Statutes ("HRS"), states, "[t]here is hereby levied and shall be assessed and collected annually privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross income, whichever is specified."

Section 237-13(2)(B), HRS, goes on to state:

Gross proceeds of sales of tangible property in interstate and foreign commerce shall

constitute a part of the measure of the tax imposed on persons in the business of selling tangible personal property, to the extent, under the conditions, and in accordance with the provisions of the Constitution of the United States and the Acts of the Congress of the United States which may be now in force or may be hereafter adopted, and whenever there occurs in the State an activity to which, under the Constitution and Acts of Congress, there may be attributed gross proceeds of sales, the gross proceeds shall be so attributed.

Under section 18-237-13-02.01(b)(3), Hawaii Administrative Rules (“HAR”), the state of Hawaii:

[D]oes not impose the general excise tax on sales of tangible personal property which originate outside of this State unless the place of delivery of the tangible personal property is in Hawaii and the seller has nexus. There must be both: (1) a place of delivery within Hawaii by the purchaser, or its agent; and (2) the seller must have nexus for the general excise tax to apply to a particular sale. The general excise tax will not be imposed if one of these elements is missing.

Taxpayer's products are delivered to customers in the State, clearly satisfying the first test. We need only determine whether Taxpayer has nexus.

Section 18-237-13-02.01(a), HAR, defines nexus as:

[T]he activity carried on by a seller in Hawaii which is sufficiently connected with the seller's ability to establish or maintain a market for its products in Hawaii. It includes issues of taxability addressed under the Due Process and Commerce Clauses of the United States Constitution to support the application of the general excise tax and the use tax under chapters 237 and 238, HRS, respectively.

To have nexus with a state, the Due Process Clause of the U.S. Constitution “requires some definite link, some minimum connection between a state and the person, property, or transaction.” *Miller Bros. Co. v. State of Maryland*, 347 U.S. 340, 344-345, *Scripto, Inc. v. Carson*, 362 U.S. 207-210-211. One way to establish nexus is “in-state physical presence,” whereby the activity carried on by the business in the State contributes significantly to the company's ability to establish and maintain a market for its products (or other business activity) in Hawaii. *Quill Corp. v. North Dakota*, 504 US 298 (1992).

The U.S. Supreme Court has uniformly found that the in-state presence of a representative of an out-of-state seller who conducts regular or systematic activities in furtherance of the seller's business, such as solicitation of sales or provision of services, creates nexus. *Scripto, Inc. v. Carson*, 362 U.S. 207 (1960); *General Trading Co. v. Iowa*, 322 U.S. 335 (1944); *Felt & Tarrant Mfg. Co. v. Gallagher*, 306 U.S. 62 (1939). See also *Tyler Pipe Industries, Inc. v. Washington Dep't of Revenue*, 483 U.S. 232 (1987); *Standard Pressed Steel v. Dep't of Revenue*, 419 U.S. 560 (1975).

The Department, in Hawaii Tax Facts 2000-1, Q&A No. 18, has explained that, “[i]n-state

physical presence” includes, but is not limited to, the maintaining of an office, inventory, or employees in the State. Although Taxpayer itself does not have a physical presence in Hawaii, Affiliate’s brick-and-mortar retail location(s) in the State establish physical presence through which Taxpayer has nexus. Affiliate clearly has in-state physical presence and acts as Taxpayer’s representative through the mutual merchandise exchange and loyalty points programs instituted on September 1, 2011.

Moreover, the Department has expressly adopted the position taken in the Multistate Tax Commission Nexus Program Bulletin (the “Bulletin”) No. 95-1 through Tax Information Release (“TIR”) 96-1. The Bulletin analyzed a company that sells computers and related items to customers in a state through direct marketing, and provides warranty repair services to its customers in that state through independent contractors. The Bulletin concluded that the practice of providing in-state warranty repair services allowed the affected state to impose sales, net income, or gross receipts excise taxes upon the company consistent with constitutional and federal statutory requirements because the in-state warranty repair services benefited the company and aided in the establishment and maintenance of the in-state market. Similarly, in this case, Affiliate’s service of accepting returns and exchanges of merchandise purchased from Taxpayer’s website, as well as the loyalty points program, benefits Taxpayer and aids in Taxpayer’s establishment and maintenance of a Hawaii market.

The California Court of Appeals has reached the same conclusion in a similar factual situation. It held that there was nexus where an affiliated in-state brick and mortar store accepted returns on behalf of an internet bookseller. *Borders Online, LLC v. State Board of Equalization*, 29 Cal Rptr 3d 176 (2005). In *Borders*, the online seller and the brick and mortar affiliate were owned by the same parent company. The online seller sold tangible goods over the internet to customers in California, but did not own or lease real property in California and did not have employees or bank accounts in the state. The court held that the affiliate’s in-state physical presence and the online seller’s return policy of allowing customers to make returns of online purchases to the affiliated brick-and-mortar retailers was sufficient to establish nexus, because it was adopted as part of a larger plan to expand its California market.

Taxpayer’s situation is analogous to *Borders*. Taxpayer is an online retailer of tangible goods and Affiliate is an affiliated company, owned by the same parent company, with brick and mortar store(s) located in the state of Hawaii. Under the current return policy, Affiliate will accept returns and exchanges of merchandise purchased from Taxpayer’s website at its in-state brick and mortar retail stores.

In summary, Affiliate, which has physical presence in Hawaii, is Taxpayer’s in-state representative due to the mutual merchandise exchange program and loyalty points program. Because Taxpayer has an in-state, physically present representative, Taxpayer has nexus with the State. Therefore, Taxpayer’s gross receipts from sales transactions with customers whose place of delivery is in Hawaii are subject to GET.

While the Department rules that Taxpayer has nexus due to the existence of an in-state, physically present representative, this ruling does not preclude the Department from determining

that Taxpayer may have nexus for different or additional reasons determined at a later date. Of particular importance is whether a taxpayer has engaged activities so as to avail the taxpayer the protection, opportunities and benefits afforded by the state of Hawaii. *See In the Matter of the Tax Appeal of Heftel Broadcasting Honolulu, Inc.*, 57 Haw. 175, 182-183, 554 P.2d 242, 248 (1976).

II. Honolulu County Surcharge

The GET rate is 4.000% for all counties in the state of Hawaii except for Honolulu County. There is a 0.500% surcharge for businesses located in and transactions with a nexus to Honolulu County.

Section 18-237-8.6-02, HAR, states, “[e]xcept as provided in this section, the gross income and gross proceeds of sale derived from a taxpayer’s sale of tangible personal property, shall be allocated to the taxation district to which the property is delivered, regardless of where the title to the property passes. The county surcharge pursuant to section 237-8.6, HRS, shall be imposed on gross income and gross proceeds for sales of tangible personal property shipped or delivered to the Oahu district provided the taxpayer has substantial nexus with the Oahu district. Substantial nexus is created by, but is not limited to physical presence, such as the presence of one or more employees, representatives, or property, in the Oahu district for purposes of the county surcharge under section 237-8.6, HRS. *See Example 5, section 18-237-8.6-02, HAR.*

According to the Department’s research, Affiliate has at least one retail location operating in Honolulu County. Since Affiliate is acting as the agent of Taxpayer and Affiliate has at least one retail store in Honolulu County, Taxpayer’s gross receipts from internet sales which have a place of delivery located in Honolulu County will be subject to the 0.500% county surcharge in addition to the 4.000% GET rate. Gross receipts from internet sales to customers in any other county in Hawaii will be subject to the 4.000% GET rate.

A business may pass the GET on to the consumer. The maximum GET rate that a business may pass on to the consumer is 4.166% where the GET rate is 4.000%. If the sale is made to a customer located in Honolulu County, the maximum rate that can be passed on to the consumer is 4.712%. Additional information regarding the Honolulu County surcharge can be found at http://www6.hawaii.gov/tax/a2_b2_7csurchg_faq.htm.

III. General Excise Tax Licensing, Reporting, Collections, and Payment

In order to obtain a GET number from the Department Taxpayer must submit a completed form BB-1 which can be obtained at <http://www.hawaii.gov/tax>. Please see the Department’s FAQ section on our website for alternate ways to obtain a GET number.

Taxpayer will need to file periodic and annual GET returns. The periodic GET return form number is G-45 and the annual GET return form number is G-49. There are no filing status options on a GET return. Honolulu County surcharges are reported on forms G-45/G-49 as well. The mandatory filing frequency of form G-45 depends on the amount of GET your business has to pay during the year:

- You must file monthly if you will pay more than \$4,000 in GET per year.
- You may file quarterly if you will pay \$4,000 or less in GET per year.
- You may file semiannually if you will pay \$2,000 or less in GET per year.

See section 18-237-30, HAR. However, if you are filing quarterly or semiannually and your tax liability is more than the amounts listed above, you must change your filing period. Please see the General Instructions for Filing the General Excise and Use Tax Returns for specific instructions. Periodic and annual returns must be filed according to the Taxpayer's required filing frequency even if there are no sales for that specific period.

For example, if a taxpayer has a semi-annual periodic filing frequency requirement and has no sales in the first half of the year but owes \$1,000 GET for sales attributable to the second half of the year, the taxpayer would file a form G-45 reporting no GET owed (first-half), a form G-45 reporting \$1,000 GET owed (second-half) and a form G-49 reconciling both G-45 forms. Each return would need to be filed by the respective due dates. If the same taxpayer has no sales to report for the entire year that taxpayer would still need to file two G-45 forms and a form G-49 reporting that no GET is owed.

The GET compliance information in section III of this letter is current as of the date of this letter and is not intended or presented to be an exclusive list of requirements to be compliant. Please see the HRS, HAR, Hawaii State tax forms/instructions, and Department publications/announcements/information releases, and other relevant informational sources for further guidance.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayers and accompanied by penalty of perjury statements executed by appropriate parties. While this office has not verified any of the material submitted in support of the request for ruling, it is subject to verification on examination.

Except for the specific ruling above, we express or imply no opinion concerning the tax consequences of the facts of this case under any other provision.

The Taxpayer has reviewed the redacted version of this ruling and agreed that it will be available for public inspection and copying.

If you have any further questions regarding this matter, please call me at [Redacted Text].

Sincerely,

TED S. SHIRAIISHI
Administrative Rules Specialist