ARE *PRO HAC VICE* COUNSEL SUBJECT TO HAWAII'S GENERAL EXCISE TAX?

RAMIFICATIONS OF *IN RE MATTER OF TAX APPEAL OF TRAVELOCITY, L.P.* ON THE GENERAL EXCISE TAXATION OF OUT OF STATE LEGAL SERVICE PROVIDERS FOR SERVICES "USED OR CONSUMED" IN HAWAII.

Contents

Author's Background

Richard Paul McClellan III is a tax lawyer practicing in Honolulu, Hawaii, since 1993. Past articles have included background on various tax requirements for Hawaii vacation rental owners and operators, the Hawaii collection statute of limitations, Hawaii tax summons enforcement, and other matters related to Hawaii tax law.

Introduction: Hawaii's Supreme Court Determines That Hawaii's General Excise Tax Reaches Services "Used or Consumed" In Hawaii

Hawaii imposes a general excise tax upon the sale of goods *and the provision of services* with its reach. "Services" include legal and other professional services. Hawaii assesses its General Excise (sometimes "GE") Tax on gross income: the services rate is 4% statewide with an additional county surcharge tax of .5% for the City and County of Honolulu.

The Hawaii Supreme Court decided a significant case interpreting the reach of the general excise tax statute to services on March 17, 2015. See, *In re Matter of Tax Appeal of Travelocity.Com, L.P., v. Director of Taxation, State of Hawaii*.

Travelocity's reasoning may apply to any out of state service provider rendering services "used or consumed" in Hawaii. Such providers, including legal service providers and in particular *pro hac vice* counsel, should consider whether *Travelocity's* rubric applies to their activities.

Outline of *Travelocity*

In *Travelocity*, online travel companies ("OTCs") had arranged hotel rooms for visitors to Hawaii hotels,[1] in a manner similar to a traditional travel agency. In 2011 and 2012, the Hawaii Department of Taxation issued 'retroactive' assessments against the OTCs for years 1999 through 2011. The assessments included general excise and transient accommodations (hotel) taxes, plus penalties and interest. The OTCs appealed the assessments to Hawaii's Tax Court. The OTCs prevailed in part at the Tax Court on the assessments: the Tax Court found that the OTCs were responsible for the GE Tax plus penalties and interest *on their gross receipts*, but determined that the OTCs were not liable for the hotel tax. Subsequently, the OTCs appealed the Tax Court's decision to the Hawaii Supreme Court. The Department of Taxation filed a cross-appeal.

[1] The contractual relationships between the OTCs and the hotels were structured in different ways. In most cases, the OTCs would collect the gross payment from the guest, deduct service and other fees, and remit the balance to the hotel.

The Hawaii Supreme Court found that the OTCs were liable for the general excise tax (plus penalties and interest) *on their services*.[2] The Court rejected the State's contention that the OTCs were responsible for the hotel tax. (The hotels, not parties to the case, were liable for the GE tax on the net room rate remitted by the OTCs.)

According to the decision, the OTCs operated websites and server farms *outside of Hawaii*. According to the decision, visitors (called "transients") were not Hawaii residents and did not make the arrangements while in Hawaii.

The Court's Interpretation And Reasoning

The general excise tax has long been held to apply to every transaction subject to Hawaii's jurisdiction and not otherwise exempted. Virtually every decision discussing the GE Tax states that the GE Tax applies to everything that it can reach.

Travelocity is a decision establishing an expanded perimeter of Hawaii's GE jurisdiction when applied to services rendered by out of state providers.

The Hawaii Supreme Court determined "that the taxable event was the receipt of income by the OTCs under agreements with transients to provide accommodations in Hawaii hotel rooms."

Those hotel rooms were located in Hawaii, and the Hawaii Supreme Court found that:

> [j]ust as transients are Hawai'i consumers when they purchase hotel rooms directly from a hotel, they remain Hawaii consumers when they purchase a Hawai'i hotel room from an OTC.

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[2] Some reports suggested that the OTCs were liable for the GE tax on the transients' entire room purchase. As noted above, this was the result of the Tax Court proceeding and was reversed and remanded on appeal. Due to a special provision of the GE statute applicable to the tourism industry, the OTCs were only liable for the GE tax on their fees and mark-up.

In reaching its decision, the Hawaii Supreme Court rejected the OTCs' arguments based on statutory interpretation and the physical location of the OTCs' server farms and websites, and declined to discuss or to mention any federal decision.

Rejection of Physical Location Argument In Favor of "Used And Consumed" Test

Hawaii's Supreme Court expressly rejected the OTCs' contention that the GE tax statute applied only to a "physical geographical limitation...where 'the particular activity' that generates income is performed." See, C.1.a.

Instead, the Hawaii Supreme Court focused upon Hawaii as the place where the services were used or consumed. According to the Court, the OTCs received a constructive benefit through their customers' use and benefit of state services, including the use of roads and access to police, fire, and lifeguard protection services. The Court also phrased this as "the protection, opportunities, and benefits afforded" by Hawaii.

As a result of this expansive interpretation of the statute, the physical locations of the OTCs' websites, server farms, and their customers were irrelevant.

Diminished Significance of Physical Presence

According to the *Travelocity* decision, the OTCs did not raise the issue of physical presence as a basis to oppose the Department of Taxation's assessments. See, Section C.1 (outlining the OTC's arguments.) As discussed above, the OTCs argued the language of the general excise tax statute, unsuccessfully.

The Hawaii Supreme Court looked to the OTCs' business model, strongly analogous to a traditional travel agency. The OTCs generated income through transactions that, according to the Court, culminated in Hawaii. This included entering contractual arrangements with Hawaii hotels for blocks of rooms and actively soliciting customers for those Hawaii hotel rooms. The decision repeatedly mentions that the right to occupy a hotel room could only be exercised in Hawaii ("wholly consumable and only consumable in Hawaii.")

The Court stated:

> Even though an OTC's agreement with a transient may take place outside of Hawaii, the agreement is effectuated with the intent that performance would occur entirely within Hawaii.

Finally, the Court added its "constructive benefit" analysis, that the transients' hotel rooms were made possible by state services, including roads, police, fire, and lifeguard protection.

Absence of Federal Analysis

The Hawaii Supreme Court did not mention the dormant Commerce Clause decisions of *Quill v. North Dakota*, 504 U.S. 298 (1992), *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977,) or any other federal case in *Travelocity*.

Under *Quill/Complete Auto Transit*, a tax will be sustained if the tax:

(1) is applied to an activity with a substantial nexus with the taxing state;
(2) is fairly apportioned;
(3) does not discriminate against interstate commerce; and,
(4) is fairly related to the services provided by the state.

Complete Auto Transit v. Brady, 430 U.S. 274, at 279 (1977.)

In the *Quill* decision, interpreting the Constitutional "nexus" requirement, the Supreme Court determined that a mail-order vendor **without any physical presence** within the state was not subject to the taxing authority of the state under the dormant Commerce Clause. 504 U.S. 298, at 317-318. *Quill* is a controversial decision, explicitly relying in part on *stare decisis* (*Quill*, at 317.) According to Justice Kennedy, the *Quill* decision was "questionable even when decided." *Direct Marketing Association v. Brohl*, 575 U.S. __ (2015), Kennedy, J., Concurring, p 3.

As noted above, according to the *Travelocity* decision, the OTCs did not argue absence of physical presence as a bar to assessment. The *Travelocity* opinion emphasizes matters apparently bearing on the first and fourth *Quill* factors, without discussing physical presence.

Background To Legal Service Providers: *Pro Hac Vice* Counsel

Attorneys are a regulated profession with licensing requirements. Hawaii does not have "reciprocity" with other jurisdictions, instead mandating prospective applicants meet its specific admission standards.

Pro hac vice ("PHV" or "PHV counsel") are non-resident attorneys licensed in other jurisdictions and without significant ties to Hawaii.

PHV counsel are permitted in Hawaii state courts at the discretion of the trial court. Appearing *pro hac vice* is not a right, but instead a privilege within the discretion of the court. *Miyashiro v Roehrig, Roehrig, Wilson*, 228 P.3d 341, 356 (ICA 2006.) PHV counsel are subject to the jurisdiction of the Hawaii Supreme Court and its Office of Disciplinary Counsel. See, Rules of the Supreme Court, Rule 1.9; Hawaii Rules of Professional Conduct, Rule 8.5; *Bank of Hawaii v. Kunimoto*, 984 P.2d 1198,1216-1218 (1999).

The federal rules are similar: PHV counsel are subject to the jurisdiction of the U.S. District Court and held to the standards required of a member of the Hawaii State Bar. See, Local Rules 83.1(e), 83.3.

Typically, in the application for PHV status before a Hawaii court, a prospective attorney will provide local counsel with a sworn statement including: (a) their state of residence; (b) that they are not a resident of Hawaii; (c) that the applicant has reviewed the local rules of procedure and (d) their consent to the disciplinary jurisdiction of the court.

An order granting PHV status will typically contain language affirming the court's jurisdiction and requiring payment, in state matters to the Hawaii State Bar Association of disciplinary and associated dues, and in federal matters (at present,) $300 to the Court's fund.

There is no requirement for PHV attorneys to demonstrate prior or prospective tax compliance or indicate any familiarity with Hawaii's tax system. In this regard, only two jurisdictions require PHV applicants to affirm compliance with jurisdictional tax laws. See, *North Carolina Pro Hac Vice Admission Registration Statement*; *South Dakota Rule 5.5(c)(5)*["in all cases, the [pro hac vice] lawyer obtains a South Dakota sales tax license and tenders the applicable taxes pursuant to Chapter 10-45.] Many lawyers might not

understand their services were subject to the general excise tax, as according to the American Bar Association, only three states have a tax on legal services in the form of a receipts tax. [Hawaii, New Mexico, South Dakota.]

Are PHV Counsel Subject To Hawaii's General Excise Tax Law?

The Hawaii Department of Taxation asserts that out of state legal service providers are subject to Hawaii's general excise tax for Hawaii-consumed services. Further, the Department contends that litigation-related services are "used or consumed" at the location of the litigation. In regulations promulgated prior to *Travelocity's* announcement, the Department of Taxation set forth its "used or consumed" position on legal (and other) services in administrative regulations.

Under *Travelocity*, the Department's "used or consumed" regulations are now approved as operative legal authority. *Travelocity*, as noted above, does not discuss operative dormant Commerce Clause precedent, but does refer to prior Hawaii "nexus" cases that do discuss such precedent. Accordingly, making another level of inference from the decision (and silent sub-text), *Travelocity* may be viewed as a state law statement of intention regarding the authority of Hawaii to tax service transactions culminating or terminating in Hawaii without reference to physical presence.

Department Of Taxation Guidance – In 2009

Hawaii Department of Taxation guidance pre-dating *Travelocity* stated that the general excise tax extended to transactions where "the primary benefit of the services" are used or received in Hawaii. See, Tax Information Release 2009-02, p 3. TIR 2009-02 and its supporting regulations contain examples of professional, including legal, services. Many of the examples in the TIR and in the apportionment regulations[3] specifically relate to legal services. **Litigation services are "used and consumed" at the location of the**

[3] The County of Honolulu has a special tax rate, known as the County Surcharge, administered by the Department of Taxation. The County Surcharge is imposed with the same sourcing analysis as the general excise tax. See, TIR 2009-02, Section II, Page 3 of 9.

litigation, according to the Department. See, for example, HAR Section 18-237-8.6-04:

> **Example 4:** Taxpayer is a law firm comprised of sixty-five attorneys. Sixty attorneys work in Taxpayer's home office in the Oahu district and five work in Taxpayer's place of business located in the Hawaii district. Taxpayer is retained by a client in the Hawaii district for a court case in the Hawaii district. Taxpayer shall allocate gross income from services performed by the attorneys to the Hawaii district where Taxpayer's services are intended to be used or consumed, notwithstanding incidental travel, meetings, or court appearances, outside of the taxation district, or receipt of support services from the place of business located outside of the taxation district. Taxpayer shall not be subject to the 0.5 per cent county surcharge regardless of the substantial nexus with the Oahu district because the legal services are intended to be used or consumed in the Hawaii district. [Eff 12/07/2006] (Auth: HRS §§231-3(9), 237-8) (Imp: HRS §237-8.6)

TIR 2009-02 also contains examples relating to transactional services.

As noted above, *Travelocity* transforms the standard set forth in the proposed administrative regulations of TIR 2009-02, and related material, into operative law affirmed by a definitive Hawaii Supreme Court decision.

"Stand Alone" Analysis

Under Hawaii law as refined by *Travelocity*, the operative questions to determine whether services are subject to Hawaii's general excise tax include:

- Is there a service activity that exists by virtue of an economic opportunity provided in Hawaii?
- Is there an economic opportunity created by an agreement with a Hawaii entity?
- Do services outside Hawaii linked to the economic opportunity culminate or terminate in a Hawaii activity?
- Is the service activity "fairly related" to the opportunities and services provided by Hawaii?

Potentially relevant federal Constitutional considerations include the *Quill/Complete Auto Transit* factors, in particular:

- Is there any physical presence in Hawaii?

PHV representation appears to meet most of the *Travelocity* standards, and, with a physical presence, even transitory, the *Quill* standards.

The opportunity to provide legal services (thereby earning fees) in Hawaii litigation is a licensed and regulated activity, governed by a branch of the state government (at least in state court cases.) To appear as a PHV counsel, an attorney must have an agreement with licensed local counsel and with the client who is a party to the Hawaii litigation. In litigation, the services are provided in the context of a specific court proceeding. While various aspects of litigation services can fairly be debated, the objective of litigation is to obtain a favorable result in the pending matter. Litigation involves the preparation of case-specific materials deliberately transmitted into Hawaii. (see footnote 5 below.) The Department of Taxation's description of litigation services as "used or consumed" at the location of the litigation has aspects of a commonsense approach.

Most PHV counsel will have case-related physical contacts with Hawaii. These contacts can come at appearances, client and witness meetings, depositions, settlement conferences, and, trial. As noted above, PHV counsel have applied for the benefit of serving as PHV counsel and have subjected themselves to the jurisdiction of the supervising court.[4] Combined with a physical presence related to the provision of legal services, under existing federal precedent PHV counsel are presumably subject to Hawaii's tax jurisdiction. A further basis for a substantial nexus could be made based upon the agreement between PHV and sponsoring local counsel. Local counsel could be viewed as an agent of the PHV attorney within the jurisdiction, even if the PHV attorney does not actually arrive physically.

Many PHV counsel have affirmatively sought to benefit from Hawaii's legal services market, including undertaking indirect marketing such as web page pronouncements of Hawaii-related appearances or special expertise relating to Hawaii law or courts.

Hawaii state courts themselves, and participation in cases in those courts, are an availment of the "protection, opportunities, and benefits" of the state. In this respect, PHV counsel are no differently situated with respect to the general excise tax than resident, Hawaii-licensed lawyers.

[4] PHV counsel can reasonably foresee being disciplined by the admitting Court or sued for malpractice in the jurisdiction where there services are provided.

Constitutional Protections Probably Do Not Apply

The current state of federal Constitutional law, relating to the dormant Commerce Clause, may act as a restraint on Hawaii from taxing via its general excise tax companies or persons without a meaningful physical presence or contact in Hawaii. In this context, *Travelocity* may be viewed as a statement of policy, as the parties in *Travelocity* did not argue lack of physical presence in that decision.

Many or most PHV counsel will have actual physical contacts, as they will interview witnesses, conduct depositions, attend hearings and settlement conferences, within the jurisdiction. Physical presence limits or eliminates any potential arguments against Hawaii's jurisdiction, as the "bright line" of *Quill* has been crossed.

For PHV counsel, even without physical contacts in Hawaii, *Travelocity* provides the state law rule: the "used or consumed" test applies.[5]

[5] See also, *In the Matter of the Tax Appeal of Heftel Broadcasting Honolulu, Inc.*, 554 P.2d 242 (1976). In *Heftel*, CBS (and others) licensed broadcast rights to a Honolulu television station and accordingly shipped in the films for broadcast (in the 1970s.) See, 554 P.2d at 244-245. CBS contended that all activities occurred outside of Hawaii and the "mere physical presence of the films and its rental" were insufficient for taxation. At 246. The State contended that the presence and rental of the films was "instate business activity." Notably, CBS had no physical presence, agents, business operations, etc., within Hawaii, and all negotiations took place outside of Hawaii. The Hawaii Supreme Court held that the fact the rights were only for broadcast in Hawaii, and that the films were shipped to Hawaii with a right of inspection and return, constituted instate business for the purpose of the GE Tax statute. *Heftel*, 554 P.2d at 247. PHV counsel should consider whether permission to practice in Hawaii is analogous to the broadcast rights, and whether transmitting specialized legal materials (for example, pleadings) for use in specific Hawaii litigation is analogous to the shipping of the films.

Consequences of Non-Compliance for PHV Counsel

In general, as with any other tax non-filers, general excise non-filers face a number of adverse consequences. The most likely consequence is the imposition of additional penalties and interest when the non-filing is uncovered. The Department of Taxation can impose penalty at rates between 25% and 50%. Interest is 8% per annum on delinquent balances.

Delay in filing back returns can also result in less favorable settlement terms.

Depending on the circumstances, PHV counsel and their firms could be required to file delinquent income tax returns, an undertaking with considerable expense and general vexation.

The State of Hawaii/Department of Taxation has criminally investigated and prosecuted a number of Hawaii attorneys for failure to file general excise tax returns. Attorneys are held to a high standard of knowledge, and many *pro hac vice* counsel appearing in Hawaii litigation appear to be part of firms that promote their considerable state and local taxation ("SALT") practices.

In addition, PHV counsel and potentially their firms face the prospect of professional discipline by Hawaii's Office of Disciplinary Counsel and on a reciprocal basis. Professional discipline or any sort could greatly reduce future PHV opportunities in Hawaii and other jurisdictions.

Recommendations

For PHV or out of state legal counsel, the first step should be to determine whether prior and current engagements are subject to the general excise tax. *Travelocity* is operative state law and, pursuant to the Department of Taxation guidance, litigation services are "used and consumed" at the location of the litigation.

The degree and duration of presence required for dormant Commerce Clause nexus is beyond the scope of this note. Nexus is not described in detail in TIR 2009-2. If necessary, a letter ruling could be requested from the State of Hawaii Department of Taxation. In this vein, notably, informal contacts (such as a telephone call, etc.) with the Department of Taxation are problematic as

two significant tax penalty decisions (including *Travelocity*) were resolved against parties with a history of such contacts with the Department.

If advisable, remedial action should be taken. Hawaii has no statute of limitations on unfiled returns. Attention should be given to Department of Taxation historical practice and announced policies on late filings.

Engagement letters should be reviewed for potential provisions relating to local tax obligations. Because most states do not tax legal services, engagement letters are likely to be silent. Current representation agreements should be evaluated and an appropriate "recapture" provision for services subject to the general excise tax evaluated for inclusion.

Income tax obligations should also be analyzed.

For PHV Counsel (or other counsel) that determine, whether in conjunction with the Department of Taxation or otherwise, that they are not subject to the general excise tax, consideration should be given to confirming in writing with the Hawaii client that the Hawaii client has reviewed its use tax obligations with respect to imported services.

Appendix A: Multi-Jurisdictional Practice Precedent May Be Irrelevant

In 1998, the Hawaii Supreme Court concluded that an out of state law firm did not render any services "within the jurisdiction" as that term was used in the Hawaii's unauthorized practice of law statute. See, *Fought & Co., Inc., v. Steel Engineering And Erection, Inc.*, 951 P.2d 487, 497-498 (1998.) In *Fought*, the Hawaii Supreme Court determined that the trial court had appropriately awarded the prevailing party attorneys' fees that included the cost of legal services from an out of state law firm that did not appear in the court proceeding.

Fought is a decision about allowable components of an attorneys' fee award. As part of that discussion, the Hawaii Supreme Court considered the nature of legal services, Hawaii's unauthorized practice of law statute, and the nature of the out of state attorney's (Kobin's) services.

The Hawaii Supreme Court stated:

Considering Kobin's activities … we hold that it did not practice law "within the jurisdiction," that is, in Hawai`i…

Fought and Kobin are both located in Oregon. Hence, Kobin did not represent a "Hawai`i client."

Furthermore, all of the services rendered by Kobin were performed in Oregon, where the firm's attorneys are licensed.

Kobin did not draft or sign any of the papers filed during the appeal, did not appear in court, and did not communicate with counsel for other parties on Fought's behalf.

Finally, Kobin's role was strictly one of consultant to Fought and Fought's Hawai`i counsel. We are convinced that Fought's Hawai`i counsel were at all times "in charge" of Fought's representation within the jurisdiction so as to insure that Hawai`i law was correctly interpreted and applied.

While Kobin undoubtedly contributed to the successful completion of the litigation in this case by its collaborative effort with Fought's Hawai`i counsel,

we cannot say, on the record before us, that Kobin rendered any legal services "within the jurisdiction."

(punctuation and spacing altered.)

The policy considerations for illegal practice of law are different for the imposition of taxes.

In addition, times have changed. When *Fought* was rendered in 1998, "place of performance" was the operative Hawaii standard for imposition of the general excise tax. See, TIR 98-9. The Kobin law firm performed its legal services in Oregon, apparently sending or transmitting some of the product of its services to counsel located in Hawaii. Under the "place of performance" test, in 1998, the Kobin firm would not have been subject to the general excise tax, even if they had physical presence in Hawaii. Next, the facts recited in *Fought* concerning the contacts of the out of state counsel (Kobin) might have been insufficient under *Quill* had *Fought* been a tax decision.

In 2009, "place of performance" was changed to "used or consumed." Few, if any, PHV counsel will have as minimal interaction with Hawaii and its court system as Kobin did on the record before the *Fought* court. The *Fought* decision is unlikely to provide a refuge for out of state legal service providers.

Appendix B: TIR 2009-2, Page 10, Exhibit "A"

Department of Taxation
Tax Information Release 2009-2

EXHIBIT "A"

DIAGRAM OF EXPORTED/IMPORTED CONTRACTING AND SERVICES
GENERAL EXCISE AND USE TAX ANALYSIS