

LINDA LINGLE  
GOVERNOR  
JAMES R. AIONA, JR.  
LT. GOVERNOR



KURT KAWAFUCHI  
DIRECTOR OF TAXATION

SANDRA L. YAHIRO  
DEPUTY DIRECTOR

STATE OF HAWAII  
DEPARTMENT OF TAXATION  
P.O. BOX 259  
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1510  
FAX NO: (808) 587-1560

**HOUSE COMMITTEE ON JUDICIARY  
TESTIMONY REGARDING HB 1154  
RELATING TO TAX ADMINISTRATION**

**TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)**  
**DATE: FEBRUARY 10, 2009**  
**TIME: 2PM**  
**ROOM: 016**

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This measure creates the Special Enforcement Section within the Department of Taxation (Department) and also provides the resources necessary to enforce the cash economy to ensure that all persons pay their fair share of tax.

The Department **strongly supports** this measure and recommends that it be passed out of committee unamended.

**I. THE TAX GAP**

In all tax systems, the government is continually working to reduce tax noncompliance known as the "tax gap." Hawaii's tax gap is estimated to be about \$2,000,000,000 in unreported and unpaid taxes every year with approximately \$1,000,000,000 attributed to the cash economy. Focusing resources on shoring up compliance in this area should be a priority to ensure that everyone pays their fair share of taxes.

**II. CASH TRANSACTIONS AND THE NEED FOR ENFORCEMENT TO ENSURE EVERYONE PAYS THEIR FAIR SHARE**

Cash-based transactions are a fundamental part of any economy. Cash is inherently private, efficient, and predictable for both purchaser and seller. However, cash transactions are also the simplest means of underreporting or non-reporting for tax purposes because no bank, no means of electronic oversight, and no intermediary maintains records of the movement of funds from one pocket to another. By focusing resources on the cash economy, the Department can ensure fairness in the tax system for those that comply without raising taxes or otherwise substantially burdening Hawaii's economy as a whole.

The purpose of this legislation is to provide the Department with the necessary resources and tools to target high-risk, cash-based transactions to shore up confidence in Hawaii's tax system. In

this regard, this measure ensures that all sectors of Hawaii's economy, including those prone to substantial underreporting, are paying their fair share of taxes.

### **III. FOCUS ON CIVIL ENFORCEMENT THROUGH A SPECIAL UNIT**

Importantly, this legislation is intended to focus on the civil collection and enforcement nature of Hawaii's tax laws—not criminal. This measure accomplishes its purpose by forming the Special Enforcement Section, a group of tax officials charged with handling sensitive and high-risk civil tax cases. The Special Enforcement Section members will be elite investigators trained in the area of tax law who will focus on the subject businesses. They will have many powers, including the ability to obtain and serve writs of entry with the assistance of police officers. These persons will not be police officers and will not have the authority to carry a firearm. This Section can be likened to a Tax SWAT team. Six FTE investigators are requested.

The Section will be given specific authority with regard to inspecting books and records. Currently, the Department already has authority to review books and records and subpoena documents. The Section will be authorized to inspect operations and premises during normal business hours as a matter of course. Moreover, where the Section suspects unlawful activity in a business' tax compliance, the Section may apply to the Circuit Court for a writ of entry (a civil search warrant) based upon probable cause, at which time the Section members may serve and search any premises with the assistance of armed police to carry out the duties of the Section.

### **IV. CASH ECONOMY CASES AS THE SPECIAL ENFORCEMENT SECTION'S FOCUS**

Due to the highly sensitive nature of cash based businesses and that many of the targeted businesses will be high-risk, the Special Enforcement Section will be the unit charged with auditing and enforcing the tax laws in this sector of the economy. Cash businesses are inherently secretive and therefore the auditing of these businesses is labor intensive. Because of the resources necessary to focus on cash cases, having one unit handle these matters is appropriate.

It is anticipated that much of the investigators' work will be undercover or surveillance work, observing the activities of businesses that operate in cash.

### **V. CITATIONS AND OFFENSES FOR BUSINESSES OPERATING IN CASH**

Currently, the Department lacks the authority to fine or assess penalties against taxpayers for many activities that are likely to give rise to tax evasion or avoidance. Though cash is an acceptable form of payment, it can easily lead to tax revenue leakage, underreporting, and other evasive behavior because it is unreported. Through this measure, the Department seeks to regulate certain cash activities for businesses by proposing civil fines and citations enforceable by the Special Enforcement Section. These fines include—

**FAILURE TO PROVIDE LICENSE UPON DEMAND**—Much like the requirement that a driver produce his or her license upon demand by the police, this infraction requires a business to produce the required GET license number upon demand. Every business is required to post their

GET license for public display.

**FAILURE TO KEEP ADEQUATE BOOKS AND RECORDS**—Every business is required by law to keep records of income, expense, deduction, and credit. There is no excuse for failing to keep adequate records, though some businesses operate with none.

**FAILURE TO RECORD A TRANSACTION**—There are two infractions for failing to record a transaction in cash, either in a receipt or register. Where there are records of a transaction in cash, there is less room for evasion. This bill proposes an infraction for failing to issue a receipt or ring the register when the means exist to do so more than 10 times per day. To issue such an infraction, investigators will have to observe a business failing to record cash transactions.

**PRICE FIXING FOR TAX AVOIDANCE PURPOSES**—It is not uncommon for cash based businesses to offer two prices—one for credit and one for cash, purely for tax evasion purposes. This bill proposes an infraction for price fixing for tax avoidance purposes where the Department can prove that the lower price was offered for cash.

The infractions in this bill vary in range from \$500 to \$3,000. The penalties are greater if the person penalized is a cash based business, as defined. The bill defines cash-based business so that businesses can delineate whether they fall into that category. A business will be considered cash-based where it operates in cash, as well as having a past history of tax issues or other noncompliance.

#### **VI. FUNDING OF THE SPECIAL ENFORCEMENT SECTION THROUGH EXISTING MEANS**

Due to budget constraints, it was necessary for the Special Enforcement Section to be funded out of the Department's current Tax Administration Special Fund. The Section will also be self-funded. It will be entitled to retain a certain amount of collected tax and all penalties, not to exceed \$500,000.

#### **VII. STRONG SUPPORT FOR THE MEASURE GIVEN CURRENT BUDGET OUTLOOK**

The Department strongly supports this measure because it will focus enforcement efforts on areas of the economy that often times goes overlooked due to their resource intensive nature. The purpose of this measure is to ensure every person pays their fair share of tax. This measure is also projected to raise substantial revenues for the general fund once operational.

This measure is projected to raise the following revenues:

FY 2010--\$11.9 million  
FY 2011--\$35.6 million  
FY 2012 and thereafter \$47.4



## HAWAII GOVERNMENT EMPLOYEES ASSOCIATION

AFSCME Local 152, AFL-CIO

**RANDY PERREIRA**

*Executive Director*

Tel: 808.543.0011

Fax: 808.528.0922

**NORA A. NOMURA**

*Deputy Executive Director*

Tel: 808.543.0003

Fax: 808.528.0922

**DEREK M. MIZUNO**

*Deputy Executive Director*

Tel: 808.543.0055

Fax: 808.523.6879

The Twenty-Fifth Legislature, State of Hawaii  
Hawaii State House of Representatives  
Committee on Judiciary

Testimony by  
Hawaii Government Employees Association  
February 10, 2009

H.B. 1154 – RELATING TO  
TAX ADMINISTRATION

The Hawaii Government Employees Association supports H.B. 1154, which will ensure that Hawaii businesses and residents are paying their fair share of taxes. This legislation will increase tax compliance of cash-based businesses by establishing a section within the Department of Taxation dedicated to pursuing tax compliance from these businesses.

Hawaii's tax gap is estimated to be about \$2 billion in unreported and unpaid taxes every year, with approximately \$1 billion attributed to the cash economy. The Department of Taxation estimates that there will be a revenue gain of \$11.9 million in the FY 2009-10, \$35.6 million in the FY 2010-11 and \$47 million in the FY 2011-12.

During these difficult economic circumstances, the State must ensure that everyone is paying the taxes they legally owe to the State of Hawaii. Thank you for the opportunity to testify in support of H.B. 1154.

Respectfully submitted,

Nora A. Nomura

Deputy Executive Director

# TAXBILLSERVICE

126 Queen Street, Suite 304

TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: ADMINISTRATION, Cash economy enforcement

BILL NUMBER: SB 972; HB 1154 (Identical)

INTRODUCED BY: SB by Hanabusa by request; HB by Say by request

**BRIEF SUMMARY:** Adds a new part to HRS chapter 231 to establish a special enforcement section within the department of taxation to carry out civil enforcement efforts as directed by the director. The special enforcement section shall have the following functions, powers, and duties to: (1) investigate reported or suspected violations of tax laws for civil enforcement purposes, including through covert means, with a stated priority of investigating cash-based businesses; (2) enforce the tax laws by issuing, enforcing, or executing citations, fines, infractions, assessments, liens, levies, writs, warrants, injunctions, or other process; (3) serve as fraud referral specialists to assist in the development and review of fraud cases; (4) organize and hold public informational meetings on issues of tax laws, including compliance deficiencies in segments of the economy, to encourage taxpayers, practitioners, or others to maintain responsibility and compliance with their tax obligations; (5) coordinate with other divisions within the department of taxation, state, county, or federal government relating to civil enforcement of the tax laws; (6) compile information and route this information within the department for proper handling; (7) conduct investigations, research, and studies of matters relevant to the complex or sensitive civil enforcement of the tax laws; and (8) perform any other acts necessary to the exercise of the functions, powers, and duties delineated.

Delineates provisions relating to the staffing of the special enforcement division by the director of taxation including the creation of six new full-time equivalent positions to serve as investigators, investigator assistants, licensed attorneys, other support staff, in addition to utilizing current and existing employees of the department of taxation.

The special enforcement division shall have the right to inspect books, records, and premises, issue warrants and writs, and have levy and seizure powers. All revenues collected from special enforcement section matters shall be deposited into the tax administration special fund.

Establishes penalty provisions for the violent interference with a tax official. Authorizes the special enforcement division to issue cease and desist citations including a monetary fine which shall not exceed \$500; provided that the monetary fine shall not exceed \$1,000 for a cash-based business.

Defines "cash-based business" as any person that operates a business where transactions in goods or services are exchanged substantially for cash and where the business is found, based upon reasonable cause including observation or evidence, to have met one of the following factors: (1) is found to have substantially under reported or misrepresented the proper amount of tax liability on any return; (2) is required to be licensed, registered, or permitted under title 14 and is not so licensed, registered, or permitted; (3) has a past pattern of noncompliance of obligations under title 14; (4) does not have a fixed and permanent principal place of business; (5) has not obtained any required tax clearance; (6) has failed

to maintain adequate books and records; (7) does not accept checks or electronic payment devices for business transactions; (8) does not issue receipts for business transactions; (9) offers price differentials when the transaction substantially involves payment of cash; or (10) any other factor relevant to describing a cash-based business capable of noncompliance.

Establish fines for the: (1) failure to produce a license upon demand; (2) failure to keep adequate books and records; (3) failure to record transaction by receipt; (4) failure to record transaction by register; (5) tax avoidance price fixing; (6) possession of currency for tax avoidance purposes; and (7) interference with a tax official.

Makes conforming amendments to HRS section 235-20.5 to provide that the revenues collected by the special enforcement section shall be deposited into the tax administration special fund with revenues in excess of \$500,000 to be deposited into the general fund. Also provides that moneys in the fund shall be used to administer the operations of the special enforcement section.

Adds a new paragraph to HRS section 237-9 to establish penalties for any person who receives gross income or gross proceeds of sales in the state and who fails to obtain a general excise tax license.

Appropriates \$500,000 out of the tax administration special fund for fiscal year 2010, and the sum of \$500,000, for fiscal year 2011, to carry out the purposes of this act, including the hiring of necessary staff, and other expenditures relating to the operations of the special enforcement section.

**EFFECTIVE DATE:** Upon approval and July 1, 2009 as noted in the measure

**STAFF COMMENTS:** This is an administration measure submitted by the department of taxation TAX-02(09). This measure is proposed to establish a special enforcement division to investigate "cash-based" businesses that are not paying their fair share of taxes. The purpose clause of this measure states that the "tax gap" for Hawaii is estimated to be \$2 billion in unreported and unpaid taxes each year with \$1 billion attributed to the cash economy. The "tax gap" is the difference in the amount of tax that is required to be reported and paid and the amount of tax that is actually reported and paid.

The justification sheet submitted with the proposed measure estimates that the revenue gain for fiscal year 2010 to be \$11,900,000; \$35,600,000 in fiscal 2011; and \$47,400,000 in fiscal 2012 if this measure is enacted as proposed. While the measure also appropriates \$500,000 to the department of taxation for each fiscal year 2010 and 2011, it is questionable whether the department will have sufficient time, resources and staff to seek out these estimated dollar amounts. While the measure allows the division to utilize covert means to investigate such cases, such investigations may result in substantial demands on manpower and resources to ascertain and detect such unreported business transactions which are not being reported for tax purposes.

It is rather curious that given much of this income goes unreported that the department can be so precise in its estimate of unreported income and the amount of tax revenues that will be realized should this measure be approved.

Digested 2/9/09

ANDREW V. BEAMAN  
ANDREW R. BUNN  
ANDREW W. CHAR  
LEROY E. COLOMBE  
RAY K. KAMIKAWA  
DANTON S. WONG  
ADRIENNE S. YOSHIHARA

BETHANY C.K. ACE  
STEVEN K. IDEMOTO  
ANNE E. LOPEZ  
KALEEN S. H. MIYASATO  
JAMES T. OTA

CHUN, KERR, DODD, BEAMAN & WONG  
A LIMITED LIABILITY LAW PARTNERSHIP  
FORT STREET TOWER, TOPA FINANCIAL CENTER  
745 FORT STREET, 9TH FLOOR  
HONOLULU, HAWAII 96813-3815  
TELEPHONE (808) 528-8200  
FACSIMILE (808) 536-5869  
www.chunkerr.com

SENIOR COUNSEL:  
EDWARD Y. C. CHUN  
WILLIAM H. DODD

GEORGE L. T. KERR  
1933-1998

GREGORY P. CONLAN  
1945-1991

**THE HOUSE  
THE TWENTY-FIFTH LEGISLATURE  
REGULAR SESSION OF 2009  
COMMITTEE ON JUDICIARY**

**Hearing date: February 10, 2009  
Testimony on HB 1154  
(Relating to Taxation)**

**Chair Karamatsu, Vice-Chair Ito, Members of the Committee:**

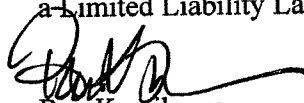
I urge your consideration in holding House Bill 1154 for the following reasons:

1. Hiring more employees and diverting the department of taxation's resources for enforcement roles in addressing the cash economy will not result in a good return on taxpayer dollars. It is difficult to assess taxes based on cash on hand or bank deposits, because you cannot assume that cash held or deposited is taxable income. To the extent the bill dispenses with these methods of proof, it is unfair and assumes the worst in taxpayers.
2. The time and resources that will need to be committed will not translate to significant assessments because the targets of cash economy investigations tend to be smaller mom and pop operations.
3. Even after an assessment is made, it will be difficult to collect on those assessments in today's economy.
4. A better approach would be for the department's audit branch to focus on single issue audits of narrower scope than the all-inclusive line by line audits that they currently conduct, which only encourages taxpayers to appeal, which can take years to resolve.
5. Funding an appeals office much like that of the IRS to be focused on resolving or settling tax audits would be a better use of taxpayer dollars.
6. The IRS has also addressed the cash economy in its National Taxpayer Advocate 2007 report. The IRS focuses more on initiatives to simplify taxes, payments alternatives, taxpayer education, forms, and the like. See [http://www.irs.gov/pub/irs-utl/arc\\_2007\\_vol\\_2.pdf](http://www.irs.gov/pub/irs-utl/arc_2007_vol_2.pdf).

Thank you for your consideration.

Very truly yours,

CHUN, KERR, DODD, BEAMAN & WONG,  
a Limited Liability Law Partnership

  
Ray Kamikawa

***SAH - Subcontractors Association of Hawaii***  
***820 Mililani Street, Suite 810, Honolulu, Hawaii 96813-2938***  
***Phone: (808) 537-5619 ✦ Fax: (808) 533-2739***

February 10, 2009

Testimony To: House Committee on Judiciary  
Representative Jon Riki Karamatsu, Chair

Presented By: Tim Lyons  
President

Subject: H.B 1154 - RELATING TO TAX ADMINISTRATION

Chair Karamatsu and Members of the Committee:

I am Tim Lyons, President of the Subcontractors Association of Hawaii and we support this bill.

The Subcontractors Association of Hawaii is composed of the following eight associations:

HAWAII FLOORING ASSOCIATION

ROOFING CONTRACTORS ASSOCIATION OF HAWAII

HAWAII WALL AND CEILING INDUSTRIES ASSOCIATION

TILE CONTRACTORS PROMOTIONAL PROGRAM

PLUMBING AND MECHANICAL CONTRACTORS ASSOCIATION OF HAWAII

SHEETMETAL CONTRACTORS ASSOCIATION OF HAWAII

PAINTING AND DECORATING CONTRACTORS ASSOCIATION

PACIFIC INSULATION CONTRACTORS ASSOCIATION



We have testified in front of just about every committee in the legislature about the number one problem reported by almost all subcontractors: that of unlicensed contractors. It is our feeling that it is just inherently unfair to require licensed contractors to get tax clearances, pay their taxes, pay their insurance and abide by a variety of other legal requirements when there is an unlicensed contracting community out there that almost parallels that of the licensed residential contractor community.

On occasion we have had discussions with unlicensed contractors to find out about the problem. Was the license too hard to get, or did they just want to run "under the radar"? In most cases, it was the latter. In some cases, they already had a tax lien and couldn't get a tax clearance because they really didn't know how to run a business and wound up spending the money before it was due on taxes.

Much of the problem here is that the consumer is the willing party to these agreements. Many contractors have informed us that they have asked their consumers why they didn't get the job? The typical reply is that "the other guy was cheaper", although he did ask to be paid in cash.

In our opinion, one of the first things to do is to follow up on every case that RICO successfully got involved in to see if taxes were paid. It is typical that if people don't pay their four (4) or four and one-half (4 1/2) GET because it is cash, they are also not going to pay corporate tax or income tax.

We think this bill is a great idea and we would urge your support.

Thank you.

PETER L. FRITZ  
414 KUWILI STREET, #104  
HONOLULU, HAWAII 96814  
TELEPHONE: (808) 532-7118  
E-MAIL: PLFLEGIS@FRITZHQ.COM

**HOUSE OF REPRESENTATIVES  
THE TWENTY-FIFTH LEGISLATURE  
REGULAR SESSION OF 2009**

**COMMITTEE ON JUDICIARY**

**Hearing date: February 10, 2009  
Testimony on H.B. 1154  
(Relating to Tax Administration)**

Chair Kim, Vice-Chair Tsutsui, members of the Committee, I am testifying in opposition this bill. There are less burdensome methods to deal with the Cash Economy.

In this bill, the Department of Taxation ("Department") borrows portions of the state liquor law. The department is essentially attempting to put a square peg in a round hole. The holder of a liquor license agrees to many terms and conditions in exchange for a liquor license. However, the same is not true for taxpayers. If this bill is enacted, all taxpayers would be treated as enemy combatants.

This bill gives the Department the right to knock on a door and demand books and records during normal business hours. Failure to comply promptly could result in a fine. In addition, it authorizes the Department to hire internal attorneys. At the present time, the Department is prohibited from having attorneys.

This bill burdens small businesses. Every small business would have to have "electronic payment devices" for transactions or risk being classified as a cash basis business presumed to be violating the tax laws.<sup>1</sup> Taxpayers could no longer use a shoebox to keep their records. Keeping records in a shoebox could subject a taxpayer to a fine.<sup>2</sup> We would no longer be able to buy gasoline at a discount for a cash purchase because the bill prohibits such price differentials.<sup>3</sup>

The abusive powers contained in this bill are not even considered in the recommendation to address the cash economy in the National Taxpayer Advocate's ("Advocate") 2007 Annual Report to Congress.<sup>4</sup> Most, if not all of the Advocate's recommendations could be put into effect using the existing resources of the Department. It is not necessary to trample upon individual rights or to further strain the budget by enacting this bill which would require an appropriation.

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<sup>1</sup> See page 14 lines 17 and 18.

<sup>2</sup> See page 14 lines 14 and 15

<sup>3</sup> See Page 14 lines 20 through 23 and Page 17 lines 1 through 12.

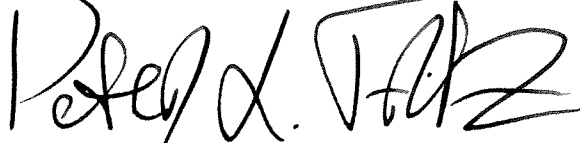
<sup>4</sup> The recommendations are attached to my testimony.

Peter L. Fritz  
Testimony on S.B. 1154  
February 10, 2009  
Page 2

As was made clear in the Taxpayer Advocate's 2007 Report, it is difficult to quantify the revenue impact of cash economy transactions because these transactions are, by definition, unreported. Accordingly, any revenue estimates should be examined closely.

Thank you for the opportunity to testify.

Very truly yours,

A handwritten signature in black ink, appearing to read "Peter L. Fritz". The signature is written in a cursive style with a large, sweeping flourish at the beginning and end.

Peter L. Fritz

## Recommendations

In summary, the National Taxpayer Advocate recommends that the IRS:

1. Establish a Cash Economy Program Office to coordinate efforts to improve compliance in the cash economy;
2. Develop a strategic plan for providing services, education, and outreach to small businesses;
3. Research and test the effectiveness of a targeted education campaign to improve attitudes about tax compliance;
4. Conduct research to identify tax rules that often confuse taxpayers and provide simplifying guidance;
  - 4a. Contract for additional analysis of the reason taxpayers made errors (including errors in interpreting the rules – not just math errors) detected in connection with the NRP, as noted in the TAS comments, above;
5. Create an “income” database to help identify underreporting and improve audit efficiency;
6. Obtain more state and local receipts-related data, match it against income reported on federal income tax returns, and use it to improve audit efficiency;
7. Revise Form 1040, Schedule C to break out income not reported on information returns;
8. Revise business income tax return forms to highlight information reporting requirements;
9. Create a preparer database that tracks errors on client returns and use it for targeted outreach and, if outreach fails, test its effectiveness as a factor in selecting returns for audit;
10. Develop a specialized audit program to detect the omission of gross receipts;
11. Research the most effective use of IRS audit resources after taking into account the direct and indirect effects of audits on tax revenue;
12. Make payment compliance easier by sending out estimated tax payment reminders to businesses that have been late in the past;
13. Encourage taxpayers to pay estimated taxes electronically using the Electronic Federal Tax Payment System (EFTPS);
14. Revise IRS collection policies to offer a reasonable payment alternative to all taxpayers who cannot fully pay what they owe; and
15. Research what the IRS can do to improve filing compliance among various taxpayer populations.