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HOUSE COMMITTEE ON JUDICIARY
TESTIMONY REGARDING HB 1155
RELATING TO TAX ADMINISTRATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: FEBRUARY 10, 2009
TIME: 2PM
ROOM: 325

This measure, among other things, conforms Hawaii tax administration law to several components of the Internal Revenue Code.

The Department of Taxation (Department) **strongly supports** this measure and encourages its passage. This measure **levels the tax administration playing field** between the state and federal levels, as well as **provides a much-needed revenue gain** in these current challenging fiscal times.

Fundamentally, this measure is about fairness in the administration of taxes amongst the government, taxpayers and tax practitioners. This measure proposes no new law that practitioners aren't already familiar with under the federal tax administration regime.

I. DISCUSSION OF OPERATIVE PROVISIONS

A. TAX RETURN PREPARER PENALTY FOR TAKING UNREASONABLE POSITIONS

The overall duty of a preparer is to prepare a proper return. The preparer can generally rely in good faith on information furnished by the taxpayer without verification. The preparer is not required to audit, examine, or review books and records, business operations, documents, or other evidence in order to verify independently the taxpayer's information.

The preparer, however, cannot ignore the implications of information furnished to or actually known by the preparer. If the information furnished appears to be incorrect or incomplete, the preparer must make reasonable additional inquiries.

In addition, the preparer must make appropriate inquiries to determine whether the taxpayer

has the substantiation required for certain deductions (e.g., travel and entertainment expenses).

This bill imposes penalties of $500 for an undisclosed, unreasonable position, and $1,000 for willful or reckless disregard of the law. An unreasonable position is one not based upon substantial authority. The Department may also seek injunctive relief to prevent certain recurring conduct. These penalties are drawn from Internal Revenue Code (IRC) sections 6694 and 7407.

The primary purpose behind this proposal is to enable the Department to hold accountable tax return preparers who take unreasonable positions on tax returns. The need to impose penalties on tax return preparers has become especially critical in the wake of the corporate fraud scandals that led to the indictment of partners and principals of a Big-4 international accounting firm and the subsequent enactment of the Sarbanes-Oxley Act.

The Sarbanes-Oxley Act holds both company executives and external accountants who assist them directly liable for any false information published in financial statements. This Department similarly seeks to hold tax return preparers responsible for their role in furnishing false information and supporting unrealistic positions on tax returns. It has become abundantly clear that those who help to prepare false or unrealistic financial information are just as responsible as those who actually furnish and report that information. This bill would enable the Department to better regulate and enforce unrealistic tax positions, and thereby facilitate the collections process and maximize tax revenues.

With the extremely generous income tax incentives available in Hawaii that are not available on the federal level, the state needs to have parameters and penalties in place to deter over aggressive and unsubstantiated conduct.

Contrary to the federal counterpart to this provision, this provision provides practitioners guidance on what substantial authority can be utilized to rebut an assessment of this penalty. This measure specifically defines the substantial authority that can be relied upon. Also, the federal counterpart presumes all positions are unreasonable unless there is substantial authority. This penalty operates in the inverse by stating that no position is unreasonable unless it is contrary to substantial authority. This should give practitioners comfort that this penalty will not be mismanaged.

RECENT DEVELOPMENT IN THIS AREA—The Department wants to point out that the IRS is scrutinizing certain "prepackaged" research credit claims that have been processed by large accounting firms. In an LMSB Memo dated January 15, 2009, the IRS targeted the federal R & D credit claims where the claims appear to lack the due diligence and lack of documentation to support the claims. This penalty would allow the Department to challenge the behavior of the tax professional who is peddling these prepackaged claims in order to ensure tax professionals are not stepping over the line.

B. ABUSIVE TAX SCHEME PROMOTERS

This bill proposes a penalty and injunctive relief (drawn from IRC sections 6700 and 7407) that apply to two distinct types of conduct: (1) making a false statement; and (2) making a "gross valuation overstatement;" with regard to promoting abusive tax shelters.

The penalty is applicable to any "person" who, directly or indirectly, organizes or assists in the organization of a tax shelter or who participates in the sale of any interests in a shelter. Although the penalty is aimed at individuals organizing and marketing interests in limited partnership tax shelters, the coverage is much broader. Any person--an individual, a corporation, a partnership, a trust, or an estate--can be a promoter. The tax shelter may be in the form of any entity, plan, or arrangement from which a tax benefit may be derived. Moreover, the plan or arrangement need not be an investment; it can include other activities, such as the sale of mail-order ministries or family trust arrangements.

C. ERRONEOUS REFUND CLAIMS

Congress recently amended the Internal Revenue Code to allow for a twenty percent penalty on any excessive refund claims. With certain of the tax incentives provided in Title 14, HRS, providing the Department of Taxation with the ability to assess a penalty for refund or credit claims where a taxpayer's claim lacks a reasonable basis will assist with the administration of Hawaii's taxes by providing a deterrent mechanism, which presently does not exist. This penalty is patterned after IRC section 6676.

Importantly for taxpayers and practitioners, the Department provides more guidance than is currently available under federal law by defining what a reasonable basis is. For example, a reasonable basis for a claim would include a 1-in-4 chance of success on the merits. Also, a reasonable basis includes innocent mistakes. The Department also provides taxpayers and practitioners with some comfort by precluding the penalty from applying where any penalty calculation results in an amount of less than $400. This means that a taxpayer has to have a refund error of $2,000 or more to be penalized under this section. The Department suggests that there is little excuse for an error of $2,000 where there is not a reasonable basis.

RECENT DEVELOPMENT IN THIS AREA—The Department wants to point out that the IRS is scrutinizing certain "prepackaged" research credit claims that have been processed by large accounting firms. In an LMSB Memo dated January 15, 2009, the IRS targeted the federal R & D credit claims where the claims appear to lack the due diligence and lack of documentation to support the claims. The IRS specifically references the § 6676 penalty for erroneous refund claims in the R & D credit area.

D. SUBSTANTIAL UNDERSTATEMENT OR MISSTATEMENTS OF TAX

Under current federal law, a taxpayer is liable for a heightened penalty for any understatements considered substantial. This penalty is equal to twenty per cent of the portion that is

attributable to a substantial understatement. An understatement is considered substantial where the difference between the amount shown on the return and the amount that should properly be on the return is greater than ten per cent of the tax required to be shown or $1,500 for individuals ($30,000 for corporations). Any understatement is reduced by any amount disclosed on a return or where there is substantial authority for the position. This penalty is drawn from IRC section 6662. This penalty increases as noncompliance increases by a taxpayer.

In perspective, this penalty would apply where an individual understates their taxable income by approximately $18,000 at the highest tax rate. For a corporation, the understatement would be equal to approximately $363,000 at the highest tax rate. As can be seen from these numbers, the Department's position in advocating for this penalty is not unwarranted. Persons making understatements to this level must be deterred.

E. EXTENSION OF STATUTE OF LIMITATION ON ASSESSMENT DUE TO SUBSTANTIAL OMMISSIONS

Federal law provides the Internal Revenue Service with the authority to revisit an assessment after the ordinary close of the statute of limitation where a taxpayer has been found to have substantially omitted an item of income. Because Hawaii's tax system is one based upon self-assessment, the government is reliant upon taxpayers to accurately and responsibly report items on their return and to submit a proper return. However, where a taxpayer is found to have omitted a large amount of any item from a return, the government is at a disadvantage after a return is filed where the ordinary three-year statute of limitations closes. This legislation recognizes the government's position and extends the statute of limitations on assessment to six years from the date the return is filed to ensure accurate taxes are paid by those who substantially omit items. This authority is patterned after IRC section 6501.

F. JOHN DOE SUMMONS AUTHORITY

As illegal tax schemes increase in complexity, the government is often unable to identify the beneficiaries of a tax scheme when the scheme or the fruits of the scheme are uncovered. In response, Congress provided the Internal Revenue Service with the authority to subpoena records of unknown persons when unlawful tax activity is detected. Upon making a showing to a court that an ascertainable class is likely to have committed tax violations and that the information is otherwise unavailable, the federal government can obtain documents from third parties. This authority, known as a "John Doe Summons," is another tool to combat aggressive tax schemes. This authority is patterned after IRC 7609(f).

G. FAILURE TO COLLECT AND PAY WITHHOLDING TAXES

This bill proposes a conformity provision to IRC section 7202, which provides a felony offense for anyone who willfully fails to collect, truthfully account for, or pay over withholding taxes. Withholding taxes are considered trust fund taxes where the employer is liable to collect an employee's income taxes and pay them over to the government. Title 14, HRS, is presently void of

criminal liability for failure to properly collect, truthfully account for, and pay over taxes owed. Failure to pay tax or other similar criminal actions are presently charged and prosecuted under a theft theory.

H. SIGNATURES PRESUMED AUTHENTIC

Almost every form filed with the Department of Taxation must be signed by the taxpayer recognizing the penalties allowed for false or fraudulent statements made in connection with a return. The Department relies in good faith that the signatures are authentic and intended to be signed as proffered. By having a presumption that the signature as it appears on the document is authentic, the Department will be relieved of what has proved to be an unnecessary administrative burden, which requires prosecutors and investigators to either establish that a taxpayer signed the return or attempt to prove such through time consuming proceedings. This bill proposes to conform to IRC section 6064, which creates a presumption that any signature on a return or other document is presumed authentic. This mechanism places the burden of showing that the signature is false or fraudulent on the taxpayer, who is in the best position to establish whether or not the signature on the return is authentic.

I. ASSESSMENT AND LEVY UPON FRAUDULENT RETURNS

Certain HRS sections are amended to conform to the federal assessment provision at section 6501, IRC. Conforming to such provisions will allow the Department to assess and levy at any time where taxpayers file a fraudulent return or do not file a return. Currently, section 235-111, HRS, requires a court determination that a taxpayer filed a false or fraudulent return before the Department may assess or levy the associated tax or liability. This requirement is especially burdensome where a taxpayer enters a guilty plea that does not result in a court determination. Moreover, this legislation conforms to taxpayer safeguards when assessments are made at any time by shifting the burden of proof with regard to the liability associated with the falsity or fraud to the government, conforming to Internal Revenue Code section 7454(a).

J. EFFECTIVE DATE

The Department wants to specifically touch on this measure's effective date. The Department proposes that this measure's effective date be retroactive and apply to any tax return where the statute of limitations on assessment remains open. In the interest of fairness to taxpayers and to limit any infringing retrospective application, the effective date also provides a "safety valve" for taxpayers by giving them the ability to come forward and amend any return with an open statute of limitations and the penalties under this measure will not apply; provided such amendment is filed by October 1, 2009. The Department believes that this effective date is fundamentally fair to taxpayers by providing the opportunity to cure the conduct that could give rise to a penalty.

The tax crimes and tax shelter penalty will apply beginning July 1, 2009.

II. REVENUE IMPACT

This legislation is projected to result in the following revenue gains:

$4,200,000 revenue gain in FY 2009-2010;
$5,300,000 million revenue gain in FY 2010-2011;
$6,400,000 million revenue gain in FY 2011-2012.

HAWAII GOVERNMENT EMPLOYEES ASSOCIATION
AFSCME Local 152, AFL-CIO

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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. 1155 – RELATING TO TAX ADMINISTRATION

The Hawaii Government Employees Association supports H.B. 1155, which will deter tax fraud by conforming Hawaii tax law to the Internal Revenue Code for preparer penalties and accuracy related penalties. More specifically, it will provide various state and county agencies with fundamental tax enforcement tools used by the IRS and other state tax agencies.

It is estimated that these changes that will increase compliance with Hawaii state tax law will achieve a revenue gain of more than $15 million over the next three fiscal years. 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. 1155.

Respectfully submitted,

Nora A. Nomura
Deputy Executive Director

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L E G I S L A T I V E

TAXBILLSERVICE

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SUBJECT: ADMINISTRATION, Adopt federal penalty provisions

BILL NUMBER: SB 973; HB 1155 (Identical)

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

BRIEF SUMMARY: Adds a new section to HRS chapter 231 to establish civil penalties for tax preparers relating to understatements due to unrealistic positions. An understatement on a tax return or claim for tax refund by a tax preparer shall be subject to a penalty of $500. The wilful attempt of the preparer to understate the tax liability or any disregard of the tax laws shall be subject to a penalty of $1,000. Delineates provisions relating to the extension of the period of collection where the tax preparer pays 15% of the penalty after a notice and demand were made.

Adds a new section to HRS chapter 231 to adopt provisions relating to the offense of promotion of abusive tax shelters and provides that such person shall be subject to a penalty of $1,000 for each unlawful activity, or if the person establishes that it is less than $1,000, 100% of the gross income derived (or to be derived) from such activity. Further delineates provisions relating to a civil action that may be brought by the state against an income tax preparer.

Adds a new section to HRS chapter 231 to provide that if a claim for refund or credit with respect to tax is made for an excessive amount, the person making the claim shall be liable for a penalty of 20% of the excessive amount; provided that there shall be no penalty assessed where the penalty calculation is less than $400. It shall be a defense to the penalty under this section that the claim for refund or credit has a reasonable basis. A person claiming the reasonable basis defense shall have the burden of proof to demonstrate the reasonableness of the claim.

Adds a new section to HRS chapter 231 to establish a penalty for the understatement or misstatement of tax amounts. Twenty percent of any underpayment attributable to any substantial understatement of tax shall be added to any tax due. A substantial understatement of tax is when the amount of the understatement exceeds the greater of: (1) 10% of the tax due for a taxable year; or (2) $1,500. In the case of a corporation, a substantial understatement of tax occurs if the amount of the understatement exceeds the greater of: (1) 10% of the tax required to be shown on a return; or (2) $30,000.

Adds a new section to HRS chapter 231 to provide for an extension of the statute of limitations for substantial omissions. If a taxpayer omits any amount of: (1) gross income or gross proceeds of sale; (2) gross rental or gross rental proceeds; (3) price, value, or consideration paid or received for any property; (4) gross receipts; (5) gallonage, tonnage, cigarette count, day, or other weight or measure applicable to any tax that is in excess of 25% of the amount stated in the return, the tax may be assessed or a proceeding in court with respect to such tax without assessment may be begun without assessment, at any time within six years after the return was filed.

Adds a new section to HRS chapter 231 to provide that any person required to collect, account for, and

pay over any tax imposed by Title 14 who wilfully fails to collect or truthfully account for and pay over the tax shall be guilty of a class C felony which shall be punishable with a fine of up to $100,000, incarceration for up to five years, or probation; provided a corporation shall be fined up to $500,000.

Adds a new section to HRS chapter 231 to provide that the fact that an individual's name is signed on a return, statement, or other document shall be prima facie evidence for all purposes that the document was actually signed by the individual.

Amends HRS section 231-7 to authorize the issuance of "John Doe Summons" wherein authority is given to subpoena records of unknown persons when unlawful tax activity is detected.

Amends HRS sections 235-111, 237-40, 237D-9, 243-14, and 251-8 to delete the provision requiring a court determination that a taxpayer filed a false or fraudulent return before the department of taxation may assess or levy the associated tax or liability and provide that the burden of proof with respect to the issue of falsity or fraud shall be on the government.

EFFECTIVE DATE: July 1, 2009

STAFF COMMENTS: This is an administration measure submitted by the department of taxation TAX-3(09). The proposed measure would establish penalties, similar to those on the federal level, for persons who prepare tax returns for compensation. This proposal focuses on tax return preparers who serve the general public by imposing a $500 penalty where the return unrealistically understates the amount of liability and a $1,000 fine for the wilful attempt to understate tax liability. The measure would also establish penalty provisions relating to the promoting of abusive tax shelters. Note well that the definition of a "tax return preparer" is any person who prepares a return. This person does not have to be a licensed tax practitioner such as a CPA or a public accountant. Thus, a property management company or a real estate agent who prepares a general excise tax return for a client would also be included under these penalty provisions. In fact, if interpreted loosely, it could be the taxpayer himself. Further, there is no provision to indicate who prepared the return. In most cases, professionals, like a CPA, will co-sign the return indicating that someone else other than the taxpayer prepared the return.

The proposed measure also: (1) establishes penalties for filing a claim for refund or credit that is an excessive amount and provides that the person filing such claim shall be subject to a penalty of 20% of the excessive amount; (2) provides that a tax of 20% shall be added to any tax due if it is determined that the tax paid is substantially understated; and (3) extends the statute of limitations for six years after the filing of a return for the omission of information to allow the department of taxation to recover unpaid taxes.

The measure would allow the department of taxation to issue a "John Doe Summons" similar to that on the federal level - a summons designed to obtain information about unidentified taxpayers is issued to an individual who is not the subject of an investigation. On the federal level, the IRS may issue such a "John Doe summons" which does not identify the person with respect to whose liability the summons is issued as an investigatory tool to uncover the beneficiaries of an illegal tax scheme.

The measure also adopts provisions for the failure to collect and pay withholding taxes and provides that such failure shall constitute a class C felony.

While adoption of the proposed measure which establishes penalty provisions that mirror the federal statutes would appear to be desirable, caution should be exercised with respect to whom it would be applied. To that end, the definition of "tax preparer" should be further clarified.

Digested 2/4/09

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THE HOUSE
THE TWENTY-FIFTH LEGISLATURE
REGULAR SESSION OF 2009

COMMITTEE ON JUDICIARY

Hearing date: February 10, 2009
Testimony on HB 1155
(Relating to Taxation)

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

I urge your consideration in holding House Bill 1155 for the following reasons:

1. The conformity to severe IRS penalties assumes that taxpayers and practitioners are adequately informed of the department of taxation's positions on major income tax and general excise/use tax issues. The IRS promulgates and publishes guidance in numerous forms, including regulations, revenue rulings, and private letter rulings, which give tax practitioners some comfort in taking tax return positions. Although the department of taxation has published guidance on grey areas, its staffing limitations prevents the promulgation of guidance in a number of areas. The practitioner in the meantime must take positions on tax returns and advice on transactions. To burden the taxpayers and practitioners with additional penalties in these circumstances is unfair.

2. Unlike the IRS, the department of taxation does not have the same avenues for meaningful internal appeals to resolve differences of opinions on assessments, which will be all the more important if significant penalties are added to the law. The IRS, for example, has a trained appeals office (in house) that successfully settles cases, and a collection due process hearing procedure (in house) with trained staff.

3. In the case of criminal penalties for failure to withhold, the department of taxation should work with taxpayers in fostering voluntary compliance by simplifying reporting procedures.

Very truly yours,

CHUN, KERR, DODD, BEAMAN & WONG,
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HOUSE OF REPRESENTATIVES
THE TWENTY-FIFTH LEGISLATURE
REGULAR SESSION OF 2009

COMMITTEE ON JUDICIARY

Hearing date: February 10, 2009
Testimony on H.B. 1155
(Relating to Tax Administration)

Chair Karamatsu, Vice-Chair Ito, members of the Committee, I am testifying in opposition to Sections 2 and 4 of this bill. Section 2 imposes a penalty on a return preparer for understatements and Section 4 imposes an additional penalty upon taxpayers who make an erroneous claim for a refund or credit. While I support conforming Hawaii's tax code to the Internal Revenue Code, conformity works best when the Department of Taxation ("Department") also conforms to the policies of the Internal Revenue Service. The Department is not ready to meet its obligations under this bill.

While the Internal Revenue Service provides significant guidance in the form of regulations, the Department provides little or no guidance to taxpayers. While the Department has claimed of abuses from Act 221 transactions, it has not promulgated any rules to help taxpayers and tax preparers know the boundaries.

This lack of guidance will give the Department the freedom to assess penalties against tax preparers who may counsel clients to enter into transactions based on an interpretation of a statute only to subsequently learn that the Department disagrees with that interpretation. Alternatively, it will become a tool to intimidate taxpayers from making claims for refunds or credits because of a fear that the Department will change its mind after they have made their investment.

This problem was very clearly illustrated when Representative Ward asked the Department about wind farms. Representative Ward inquired about a wind farm which was assembling using existing technology which had received a favorable Comfort Letter. Representative Ward asked Johnnel Nakamura if a similar project would receive a favorable ruling today. Ms. Nakamura said that it would not. There has been no public announcement about this change in position by the Department. It is more likely than not that people have been soliciting investments for renewable energy projects that are using existing technology without realizing that the Department will no longer provide them with a favorable Comfort Letter. Unfortunately, the Department's position on the status of credits for the existing wind farm project is unknown. Given the Departments new position, are the investors potentially liable for an erroneous claim for a credit or refund? Will the Department assess an erroneous refund claim

against a taxpayer who claims a credit for an investment in a wind farm that is identical to the one mentioned by Representative Ward, but does not have a Comfort Ruling? A company does not have to request a Comfort Luling.

On February 29, 2008, the Department revoked all guidance regarding imported and exported services. The Department did not offer any explanation for the revocation. Unlike the Internal Revenue Service, which would have allowed taxpayers to rely on the guidance until new rules had been published; the Department's revocation stated that taxpayers cannot rely on the prior guidance. On January 9, 2009, I was told that replacement rules would not be published in 2009. This places taxpayers and tax preparers in a bind. Will they be subject to penalties for claims from transactions under the old guidance? How can a taxpayer enter into new transactions when there is no substantial authority to help them avoid potential penalties?

Unlike the Internal Revenue Service, the Department does not publish information about pending rules projects; I wrote a letter to Johnnel Nakamura requesting such information. She provided the following list of current rules projects:

Rules on the Scientific Contract exemption under Section 237-26
Amendments to Rules Regarding Contractors
Rules regarding the Film Industry
Rules Regarding Imported and Exported Services
Rules Regarding the Renewable Energy Credit
Rules Regarding Non-profit Corporations
Amendments to Rules Regarding Conveyances Tax
Amendments Regarding Individual Tax Forms

I thought the descriptions were too vague. They certainly did not meet the standard that is used by the Internal Revenue Service in its Priority Guidance Plan.[1] For example are the Rules Regarding Non-profit Corporations for income tax or general excise tax issues? What specific issues are to be addressed by these rules? While I asked for clarification on September 7 and October 13, 2008, I am still waiting. On January 22, 2009, I was informed that because of "budget cuts and hiring freezes" that I should not expect a response to my request. As a practitioner who works with a nonprofit organization, I am extremely interested in knowing if there are any potential areas that need to be addressed by the entity. However, because I have not received any clarification, I will be unable to offer such advice.

With respect to what is substantial authority[2], I respectfully submit that Tax Information Releases, Press releases or official pronouncements of the Department should not be considered substantial authority. These documents do not require a public hearing. They are often position statements driven by government opinions from outside the Department.

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[1] Each year, the Internal Revenue Service publishes its Priority Guidance Plan ("Plan"). The Plan describes the regulations and guidance that will be issued by the Internal Revenue Service that year. It contains descriptions of each project and the areas that are to be addressed.

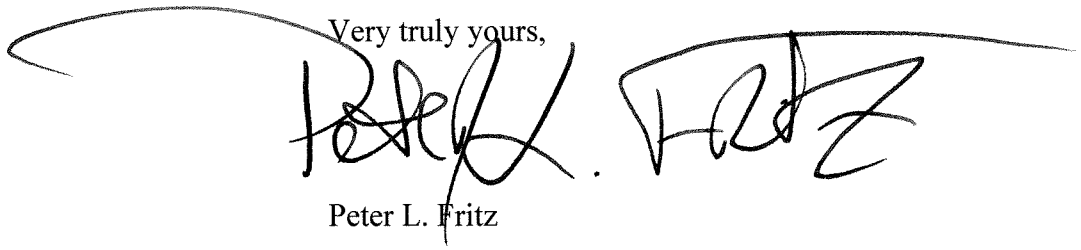
[2] See Page 6, lines 6 through 22 and Page 7 lines 1 through 3.

Finally, the Department wants Sections 2 and 4 to be for returns that have already been filed which are still "open" to audit. This would unfairly punish taxpayers and tax preparers who would be exposed to penalties for failure to disclose a position, when there was no obligation to disclose a position when the return was filed. While the Department says that an amended return can be filed by October 1, 2009 to correct this potential problem, the Department fails to mention that the amended return would extend the statute of limitations for conducting an audit. Therefore, if there was only one month left under the statute of limitations, the filing of an amended return would extend the statute for an additional 3 years or 6 years under Section 6 of this bill.

The penalties proposed in Sections 2 and 4 of this bill effectively allow the Department to selectively enforce an administration policy against certain tax credits or incentives by targeting taxpayers who make claims and/or tax preparers who prepare returns with such claims. Because of the lack of guidance, it creates a potentially chilling atmosphere where investments suffer because of a fear of these penalties. This is not a good policy in an economic downturn.

Thank you for the opportunity to testify.

Very truly yours,



Peter L. Fritz