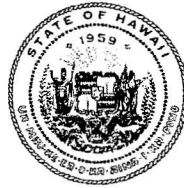


LINDA LINGLE
GOVERNOR

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DIRECTOR OF TAXATION

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**HOUSE COMMITTEE ON FINANCE
TESTIMONY REGARDING SB 972 SD 2
RELATING TO TAX ADMINISTRATION**

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: MARCH 25, 2009

TIME: 4PM

ROOM: 308

As amended, this measure seeks to ensure that taxpayers pay their fair share of tax by directing the Department of Taxation to identify "Tax Gap" taxpayers by cooperating and coordinating with other government agencies, information-sharing, and requiring tax clearances from all businesses regulated by the Department of Commerce & Consumer Affairs.

The Department of Taxation (Department) **opposes this measure, as amended, and requests that its original contents be inserted.**

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.

III. COMMENTS ON CURRENT VERSION

THE DEPARTMENT CURRENTLY PARTICIPATES IN INTER-GOVERNMENTAL COORDINATION

As a general matter, the Department supports efforts to work with other government agencies—federal, state, and local—to ensure that taxpayers maintain maximum compliance. The Department routinely coordinates with other tax agencies on tax compliance and remains active with tax associations to keep up-to-date on the state-of-the-art when it comes to tax enforcement.

FOCUS ON THE CONSTRUCTION INDUSTRY IS SHORT-SIGHTED

As amended, this measure appears to focus greatly on the construction industry. While the Department does not dispute that the cash-based construction industry has its share of tax noncompliance, the Department believes that the statutory focus on the construction industry needs to be revisited. Almost every industry in Hawaii could potentially have Tax Gap implications and are not immune from tax cheats. The Department prefers the original contents of this measure because it focused on every industry where cash was a substantial part of its economy in order to shore up confidence in the tax system.

TAX CLEARANCE REQUIREMENT WILL BE UNDULY BURDENSOME AND IS ANTI-BUSINESS FOR THOSE THAT COMPLY

The Department has strong concerns with the amendments that require every business regulated by the Department of Commerce & Consumer Affairs to obtain a tax clearance. The focus on the original contents of this measure was to ensure the business community that those taxpayers that are compliant with their tax obligations will not be burdened by the cash economy Special Enforcement Section. This measure, as amended, effectively punishes all regulated businesses for the bad acts of a few. The Department intentionally drafted the original version of this measure to avoid burdening all businesses for the cheating of a few.

The tax clearance requirement, though valuable, has limitations because it is a clearance only that the taxpayer has paid what they say they owe. It is not an upfront "audit." Nonetheless, the tax clearance system is effective in ensuring that taxpayers are paid-up. The Department supports the intent of requiring tax clearances for these industries, but without sufficient resources, this requirement will unduly burden both the Department and taxpayers. Tax clearances can be a lengthy process because each taxpayer has to be cleared for all taxes. Additional resources will be necessary to accomplish the intent of this measure within a reasonable time—more resources than were requested in the original measure.

If the Committee deems it necessary to continue the tax clearance requirements, the Department suggests that the bill be amended to provide that the taxpayers will be cleared for income and general excise taxes, "and any other tax deemed relevant by the Department." Currently, only income and general excise taxes are available electronically for expedient processing. Having to clear a person who is a beautician for liquor taxes or transient accommodations taxes is required

under current law; though is likely ultimately irrelevant. Providing the Department with the discretion to clear the "other" taxes will greatly assist with efficiencies.

IV. PREFERENCE FOR THE ORIGINAL CONTENTS

The Department strongly recommends that the current version eliminated in favor of its original contents. The original cash economy measure struck the right balance between enforcing taxpayer behavior that erodes confidence in the self reporting tax system; yet also not burdening those that comply.

The purpose of the original contents 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.

FOCUS ON CIVIL ENFORCEMENT THROUGH A SPECIAL UNIT

Importantly, the original is intended to focus on the civil collection and enforcement nature of Hawaii's tax laws—not criminal. Civil enforcement is accomplished 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. 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.

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.

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. 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. An infraction for price fixing for tax avoidance purposes is proposed where the Department can prove that the lower price was offered for cash.

The infractions vary in range from \$500 to \$3,000. The penalties are greater if the person penalized is a cash-based business, as defined. Cash-based business is defined 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.

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.

V. REVENUE IMPACT

The original contents of this measure resulted in the following revenue gains:

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

In its current form, it is indeterminate how much revenue gain this measure will produce. In order to properly carry out the intent of this measure, the Department would need adequate resources to staff the tax clearance undertaking presented in this bill. Assuming sufficient resources are provided, it is possible that this measure will produce considerable revenue gains.



**TESTIMONY OF THE STATE ATTORNEY GENERAL
TWENTY-FIFTH LEGISLATURE, 2009**

ON THE FOLLOWING MEASURE:

S.B. NO. 972, S.D. 2, RELATING TO TAX ADMINISTRATION.

BEFORE THE:

HOUSE COMMITTEE ON FINANCE

DATE: Wednesday, March 25, 2009 **TIME:** 4:00 PM

LOCATION: State Capitol, Room 308

TESTIFIER(S): Mark J. Bennett, Attorney General,
or Cynthia M. Johiro, Deputy Attorney General

Chair Oshiro and Members of the Committee:

The Department of the Attorney General provides these comments regarding possible legal problems in this bill.

This bill directs the coordination of the appropriate state agency (namely, the Department of Taxation) and various federal agencies, unions, and other state agencies, as applicable, to identify taxpayers who are delinquent in filing general excise returns and paying the appropriate general excise taxes. These federal and state entities would share database and intelligence as well as coordinate enforcement and auditing. This bill also directs the Department of Taxation to refer all delinquent taxpayers who have an outstanding tax balance that is greater than five years old to a private collection agency for collection.

First, as presently drafted, this bill may violate the Due Process Clause, article I, section 5, of the Hawaii State Constitution, as well as the Fourteenth Amendment of the United States Constitution. The Due Process Clause of the Hawaii State Constitution states in part: "No person shall be deprived of life, liberty or property without due process of law. . . ." At page 3, lines 10 through 19, this bill empowers the Department of Taxation to stop any construction project in the state if any project participant has not timely filed its general

excise tax returns or paid the appropriate general excise tax. However, stoppage of work may deprive a taxpayer-participant, whether it is the owner of the developed property or the contractor, who is not a delinquent taxpayer, of the right to proceed on its construction project, without a process to appeal the work stoppage.

In Klinger v. Kepano, 64 Haw. 4, 635 P.2d 938 (1981), the Hawaii Supreme Court held that notice by publication and posting alone of a pending tax sale was insufficient due process. The Klinger case noted that "an elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections . . . The notice must be of such nature as reasonable to convey the required information." Id. at 10, 635 P.2d 942, quoting Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 70 S. Ct. 652, 94 L. Ed. 865 (1950). In other words, if there is a dispute as to the delinquency of the taxpayer, the taxpayer or the non-delinquent taxpayer who is the other party to the contract, should have a forum to be heard before work is ceased.

Moreover, stoppage of work in such a proposed way may expose the State to a possible action against it for tortious interference of contract if, for instance, there is a mistake as to the delinquency of the taxpayer.

Second, at page 3, lines 13 through 14, this bill authorizes "the appropriate state agency" to stop construction projects for delinquencies in the filing of general excise returns and payment of general excise taxes. However, the term "the appropriate state agency" is vague and ambiguous.

Third, this bill directs the Department of Taxation to share certain general excise tax information with other state and federal agencies. However, this bill conflicts with section 237-34, Hawaii Revised Statutes, which prohibits the Department of Taxation from disclosing tax returns and return information, with certain enumerated

exceptions, because the bill does not amend section 237-34 to allow the federal and state agencies designated in this bill to be privy to confidential tax information.

Finally, this bill proposes to ensure that construction contractors pay their general excise taxes through coordination with governmental procurement agencies and by requiring a tax clearance at the time of license renewal. These provisions will neither address purely private construction projects, nor will they ensure the payment of taxes by contractors who underreport or who fail to report gross receipts on their general excise tax returns.

We respectfully ask the Committee to hold this bill.



LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

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LAWRENCE M. REIFURTH
DIRECTOR

RONALD BOYER
DEPUTY DIRECTOR

TO THE HOUSE COMMITTEE ON FINANCE

TWENTY-FIFTH LEGISLATURE
Regular Session of 2009

Wednesday, March 25, 2009
4:00 p.m.

WRITTEN COMMENTS ON SENATE BILL NO. 972, S.D. 2, RELATING TO TAX ADMINISTRATION.

TO THE HONORABLE MARCUS R. OSHIRO, CHAIR,
AND MEMBERS OF THE COMMITTEE:

The Professional and Vocational Licensing Division of the Department of Commerce and Consumers Affairs ("PVL/DCCA") appreciates the opportunity to submit comments on S.B. 972, S.D. 2, Relating to Tax Administration. Our comments are limited to section 2 of the bill, subsection (c) (page 4, lines 9-14). PVL/DCCA's purpose in submitting comments is to ensure there is an understanding of the impacts of subsection (c).

As subsection (c) sets forth, the Department of Taxation ("DoTax") shall coordinate with DCCA to require tax clearance certificates prior to licensure or renewals for industries licensed pursuant to specified chapter numbers referenced in the bill. For PVL/DCCA, this amounts to 63 different licensed professionals. Provided there is an

understanding that while DoTax may coordinate with respective licensing boards and programs in DCCA on the matter of requiring a tax clearance for licensure, the decision to actually require this should be made only after full and open discussion with all stake holders, and all negative impacts addressed. Moreover, any new licensing requirement should be established in the licensing authorities' respective licensing chapters.

While PVLD/DCCA's licensing boards and programs are open to discussing the merits of a tax clearance requirement with DoTax, we feel it necessary to set forth the following concerns that will be immediately raised in discussions on this issue with the licensing authorities:

- Of the 63 licensed professionals in the PVLD/DCCA group, we have no knowledge to confirm that any or all these licensees operate on a cash basis. We are, however, aware that such licensees are primarily persons employed by a business. Thus, we do not know why such professionals are singled out to be in the cash basis "tax gap taxpayers" group covered by the S.D. 2;
- With licensing, a requirement such as a tax clearance would be applied to all in the given profession. No distinction is made in licensing laws on the person's source of income;
- Tax clearances, as currently used for licensing purposes by PVLD/DCCA licensing authorities, are required to license a business where financial integrity is among the qualifications to be licensed. Not all business license types have a financial integrity component. Also, of the 63 licensed professionals in the PVLD/DCCA group, the vast majority are individuals who

are licensed based on their competency to practice. Competency is demonstrated through satisfying such requirements as education, experience, and passing a licensing exam. A tax clearance for such individuals would not appear to have a nexus to their competency to practice and if there is no nexus to competency, it would appear inappropriate to impose this requirement for licensing purposes;

- Requiring a tax clearance of licensed professionals would create a burden on applicants for licensure and licensees. Of the 63 licensed professionals in the PVLD/DCCA group, shortages of many of the practitioners exist and adding a requirement for a tax clearance would disincentivize licensing and practicing in Hawaii. In addition, if there is no nexus to, or reason they need to obtain, a tax clearance to demonstrate their competency to practice, this could be regarded as a deterrent to licensing which would be contrary to all efforts by the PVLD/DCCA licensing authorities to make the licensing process free of restrictive requirements;
- Applicants for licensure and current licensees include practitioners who reside out-of-state, who may or may not actually work in Hawaii. Such licensees do not appear to be the "tax gap taxpayers" targeted by this bill but nevertheless would be subject to the tax clearance if imposed for licensure. *With licensing, distinction is not made if a person is or is not in-State. The person is allowed to apply for and retain a license irrespective of residency.* The ability for such

out-of-state applicants and licensees to obtain a tax clearance, or minimally obtain a meaningful tax clearance, is questionable;

- PVLD/DCCA expects that with imposition of a tax clearance, processing of applications and renewals will be delayed. Each additional document to be reviewed for compliance in the licensing and renewal process contributes to delays. Given the magnitude of 63 licensed professionals to be potentially impacted with a tax clearance requirement, there will be significant impact to our timely processing. Our timeliness affects a newly licensed and renewed licensee's ability to practice in Hawaii – and thus to make a living – as soon as possible;
- Should PVLD/DCCA determine that there will be added costs with the necessity for additional full time employees to manage the additional strain on processing applications and renewals due to the inclusion of the tax clearance requirement, such costs will be passed onto the licensees. Increased fees for such purposes will be opposed;
- Many of the 63 licensed professionals in the PVLD/DCCA group are provided the ability to renew online. If a tax clearance requirement is imposed for renewal, it will depend on whether DoTax can provide the support to furnish tax clearances through our online system as to whether online renewal will remain possible. Currently we work with DoTax for Contractors and Pest Control Operators renewals because both professions require a tax clearance. While DoTax does support their end to clear the tax clearance

requirement as part of our online process, it has put a strain on their resources. Again, given the magnitude of 63 licensing professionals to be added to DoTax's workload, we would have concerns for DoTax's ability to provide the needed support to make our online renewal system efficient. If the efficiency or effectiveness of our online system is to be negatively affected, PVLD/DCCA may have to reconsider whether online renewal is a workable option for the impacted professionals;

- It is interesting to note that in subsection (c), three specific professions are named: cosmetology, contractors, and real estate brokers and salespersons. As indicated above, a contractor's license requires a tax clearance (both with initial licensing and with biennial renewal). Licensees under the cosmetology and real estate licensing law do not require a tax clearance, but we also have no confirmation that any or all operate on a cash basis; and
- If this bill is attempting to target licensed professionals that operate on a cash basis, there might be a better understanding of achieving the specific goals of the bill if we knew what professionals these were. However, until that is known, the impacts above would appear to outweigh any consideration of imposing a tax clearance requirement for all 63 licensed professionals in the PVLD/DCCA group.

Thank you for allowing us to provide our perspective – specifically on section 2 of the bill, subsection (c) – as you deliberate on the S.D. 2,.

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, SD-2

INTRODUCED BY: Senate Committee on Ways and Means

BRIEF SUMMARY: Adds a new section to HRS chapter 231 to require the department of taxation to coordinate with federal agencies to require a general excise tax clearance certificate for all construction projects in Hawaii. The appropriate state agency shall have the authority to stop the construction project if any periodic general excise tax returns with payment are not timely or accurately filed, as appropriate, or if the federal procurement officers do not reasonably assist the department in ensuring that each construction project pays general excise tax in a timely and accurate manner.

Require the department of taxation to coordinate with unions and federal agencies, such as United States Immigration and Customs Enforcement, on database and intelligence sharing, along with cooperative auditing of construction work sites for compliance with the general excise tax reporting and income tax withholding requirements. Allows that the appropriate state agency shall have the authority to stop the construction project if an owner, developer, employer, or similar entity is not paying income, withholding, general excise, or employment taxes to the state in a timely and accurate manner.

Requires the department of taxation to coordinate with the department of commerce and consumer affairs to require a general excise tax clearance certificate prior to license issuance or renewals for regulated industries licensed under chapters 436 through 471, such as those regulated under chapters 439 (beauty culture), 444 (contractors), and 467 (real estate brokers and salespersons).

Directs that the department of taxation shall utilize its computer database data to analyze taxpayer information across several tax systems and filing statuses. The computer-assisted variables that the department analyzes should focus on are primarily centered around matching the reported amount of taxes paid on the taxpayer's return with other taxes that the taxpayer would be subject to under the tax laws of this state.

EFFECTIVE DATE: July 1, 2090

STAFF COMMENTS: This was an administration measure submitted by the department of taxation TAX-02(09). 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.

This measure proposes to identify cash-based businesses that may not be paying their fair share of income, general excise, withholding and employment taxes through the department of taxation's computer database rather than establishing a special enforcement section of the department of taxation as

proposed in the original measure, thereby relieving the department of utilizing additional manpower and resources. On the other hand, this measure gives the department such broad powers that in the wrong hands or with the wrong intent could create a department of taxation that may abrogate the rights of innocent taxpayers. Care should be exercised in granting such broad powers to enforce the tax laws especially where the department has provided little or no guidance on the interpretation of the law.

Digested 3/24/09

SAH - Subcontractors Association of Hawaii

820 Mililani Street, Suite 810, Honolulu, Hawaii 96813-2938

Phone: (808) 537-5619 + Fax: (808) 533-2739

March 25, 2009

Testimony To: House Committee on Finance
Representative Marcus R. Oshiro, Chair

Presented By: Tim Lyons
President

Subject: S.B 972, SD 2 - RELATING TO TAX ADMINISTRATION

Chair Oshiro 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 separate and distinct 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 paid for 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 ½) 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.