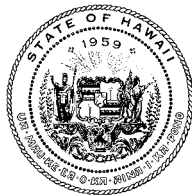


SB972

EDT

LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR



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**SENATE COMMITTEE ON ECONOMIC DEVELOPMENT & TECHNOLOGY
TESTIMONY REGARDING SB 972
RELATING TO TAX ADMINISTRATION**

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

DATE: FEBRUARY 18, 2009

TIME: 1:15PM

ROOM: 016

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. 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

The Department's revenue impact methodology is as follows—

1. Apply the Hawaii's 0.5% to the IRS' estimate "tax gap" of \$345 billion in 2001.
2. Assume 50% of the "tax gap" is due to the "cash economy".
3. Assume that the Department is able to collect 0.5% in direct revenue (direct cases being worked on) and 5% in indirect revenue (deterrence effect) from the "cash economy."
4. Assume ability to collect 25% in yr 1, 75% yr 2, and 100% yr 3.
5. $0.5\% \times \$345 \text{ billion} \times 50\% \times 5.5\% = \47.4 million
6. \$0.5 million goes to tax administration special fund; the remainder goes to general fund.

SAH - Subcontractors Association of Hawaii

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February 18, 2009

Testimony To: Senate Committee on Economic Development and Technology
Senator Carol Fukunaga, Chair

Presented By: Tim Lyons
President

Subject: S.B 972 - RELATING TO TAX ADMINISTRATION

Chair Fukunaga 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 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.

FEB 17 2009 035P

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THE SENATE
THE TWENTY-FIFTH LEGISLATURE
REGULAR SESSION OF 2009

COMMITTEE ON ECONOMIC DEVELOPMENT AND TECHNOLOGY

Hearing date: February 18, 2009
Testimony on S.B. 972
(Relating to Tax Administration)

Chair Fukunaga, Vice-Chair Baker, members of the Committee, I am testifying as a citizen 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 page in a round hole. The holder of a liquor license consents to certain 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.¹ Taxpayers could no longer use a shoebox to keep their records. Keeping records in a shoebox could subject a taxpayer to a fine.² We would no longer be able to buy gasoline at a discount for a cash purchase because the bill prohibits such price differentials.³

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. 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.

¹ See page 14 lines 17 and 18.

² See page 14 lines 14 and 15

³ See Page 14 lines 20 through 23 and Page 17 lines 1 through 12.

Rather than enact this bill which requires an appropriation and the hiring of new personnel, the Department should follow the recommendations of the Advocate to achieve effective tax administration. Some items from the Advocate's report that the Department could implement are:

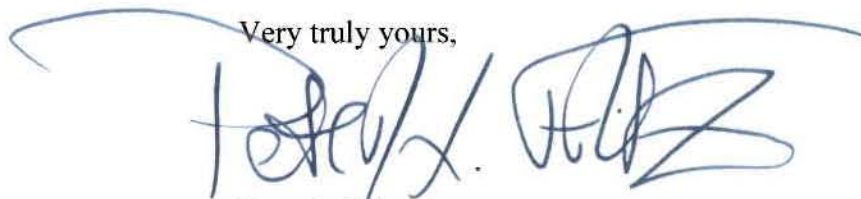
1. Establish a Cash Economy Program Office to coordinate efforts to improve compliance in the cash economy;
2. Develop a strategic plan for providing services, education, and outreach to small businesses;
3. Research and test the effectiveness of a targeted education campaign to improve attitudes about tax compliance;
4. Conduct research to identify tax rules that often confuse taxpayers and provide simplifying guidance;
 - a. Contract for additional analysis of the reason taxpayers made errors (including errors in interpreting the rules – not just math errors) detected in connection with a research program;
5. Create an "income" database to help identify underreporting and improve audit efficiency;
6. Obtain more receipts-related data from the IRS and match it against income reported on federal income tax returns, and use it to improve audit efficiency;
7. Revise business income tax return forms to highlight information reporting requirements;
8. 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;
9. Develop a specialized audit program to detect the omission of gross receipts;
10. Research the most effective use of audit resources after taking into account the direct and indirect effects of audits on tax revenue;
11. Make payment compliance easier by sending out estimated tax payment reminders to businesses that have been late in the past;

12. Revise collection policies to offer a reasonable payment alternative to all taxpayers who cannot fully pay what they owe; and
13. Research what can be done to improve filing compliance among various taxpayer populations.

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 blue ink, appearing to read 'Peter L. Fritz', with a large, sweeping flourish extending from the top left of the signature.

Peter L. Fritz

ANDREW V. BEAMAN
ANDREW R. BUNN
ANDREW W. CHAR
LEROY E. COLOMBE
RAY K. KAMIKAWA
DANTON S. WONG
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**THE SENATE
THE TWENTY-FIFTH LEGISLATURE
REGULAR SESSION OF 2009**

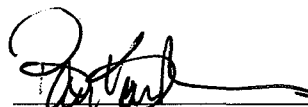
**COMMITTEE ON ECONOMIC DEVELOPMENT AND
TECHNOLOGY**

**Hearing date: February 18, 2009
Testimony on SB972
(Relating to Taxation)**

Chair Fukunaga, Vice Chair Baker, Members of the Committee:

I urge your consideration in holding Senate Bill 972 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 to this effort will not translate to significant assessments because the targets of cash economy investigations tend to be smaller mom and pop operations. Even after an assessment is made, it will be difficult to collect on those assessments in today's economy.
3. 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, and which can take years to resolve.
4. Establishing an appeals office much like that of the IRS to focus on resolving or settling tax audits would foster tax payments much faster.
5. Other suggestions include: (a) matching income tax returns against IRS Sch. C (sole proprietors) and Sch. K-1 (rental/partnership) income against GET reports; (b) coordinating with DCCA on requiring tax clearances for regulated industries; (c) coordinating with federal procurement officers to require tax clearances on federal construction jobs; and (d) coordinating with federal immigration and unions on leads to work site compliance with income tax withholding requirements.
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.



Ray Kamikawa



HAWAII GOVERNMENT EMPLOYEES ASSOCIATION

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The Twenty-Fifth Legislature, State of Hawaii
Hawaii State Senate
Committee on Economic Development & Technology

Testimony by
Hawaii Government Employees Association
February 18, 2009

S.B. 972 – RELATING TO TAX
ADMINISTRATION

The Hawaii Government Employees Association supports S.B. 972, 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 forming a section within the Department of Taxation dedicated to pursuing tax compliance from these businesses. This measure also provides various enforcement tools, including the authority to issue monetary fines, adopt fines by rule, and issue injunctions.

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 FY 2009-10, \$35.6 million in FY 2010-11 and \$47 million in FY 2011-12 if S.B. 972 is enacted.

During these difficult economic circumstances, the state must ensure that everyone is paying the taxes they legally owed to the State of Hawaii. Thank you for the opportunity to testify in support of S.B. 972.

Respectfully submitted,

Nora A. Nomura
Deputy Executive Director