SB 973

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THE SENATE
THE TWENTY-FIFTH LEGISLATURE
REGULAR SESSION OF 2009

COMMITTEE ON WAYS AND MEANS

Hearing date: February 10, 2009
Testimony on SB 973
(Relating to Taxation)

Chair Kim, Vice-Chair Tsutsui, Members of the Committee:

I urge your consideration in holding Senate Bill 973 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,

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Comments

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THE SENATE
THE TWENTY-FIFTH LEGISLATURE
REGULAR SESSION OF 2009

COMMITTEE ON WAYS AND MEANS

Hearing date: February 10, 2009
Testimony on SB 973
(Relating to Tax Administration)

Chair Kim, Vice-Chair Tsutsui, 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 ruling.

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.

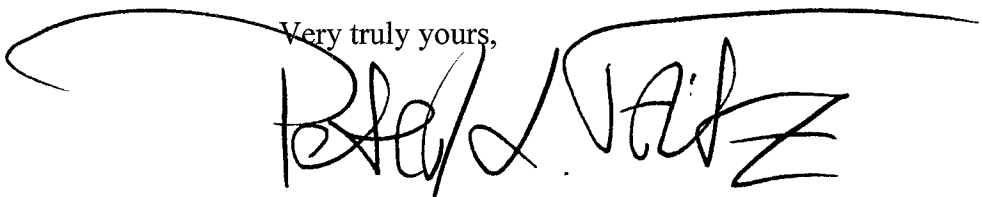
[2] See Page 6, lines 6 through 22 and Page 7 lines 1 through 3.

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