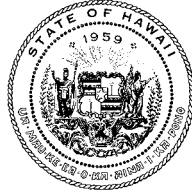


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To: The Honorable David Y. Ige, Chair  
and Members of the Senate Committee on Ways and Means

Date: Tuesday, March 20, 2012  
Time: 9:00 a.m.  
Place: Conference Room 211, State Capitol

From: Frederick D. Pablo, Director  
Department of Taxation

**Re: H.B. No. 1695, Relating to Taxation**

The Department of Taxation (Department) appreciates the intent of H.B. 1695 and offers the following comments for the Committee's consideration.

H.B. 1695 prohibits penalties for substantial understatements or misstatements and for erroneous claims for refund or credit from being added to tax underpayments on which certain other penalties are already imposed.

Section 1 – Amending § 231-36.4, HRS

The IRC has separate criminal and civil penalty sections regarding the willful failure to collect and pay over tax. IRC section 7202 is the criminal section and does not preclude any kind of stacking. IRC section 6672 is the civil penalty section and precludes accuracy-related penalties to be stacked on the 100% penalty assessed under IRC section 6672. Stacking is precluded under IRC section 6672 because of the severity of the penalty at 100%. However, stacking is allowed for penalties assessed for erroneous claims for refunds or credits under IRC section 6676.

Specifically, if the amendment to section 231-36.4, Hawaii Revised Statutes (HRS) is passed in this form, it may have the effect of preventing prosecution in cases where the Department has assessed a penalty for erroneous claim of refund or credit. The Department defers to the Department of the Attorney General regarding whether the bill would prevent criminal prosecutions.

Section 231-36.4, HRS regarding the wilful failure to collect and pay over tax is criminal in nature because a conviction can result in a fine, imprisonment or probation. The Department suggests that section 1 be deleted. If it is the Committee's intent to conform to the Internal Revenue Code (IRC), the Department recommends the Committee adopt a civil penalty statute similar to IRC section 6672 containing a civil accuracy-related anti-stacking provision without amending HRS section 231-36.4.

#### Section 2 – Amending § 231-36.6, HRS

Section 231-36.6 permits a civil penalty to be assessed in cases of substantial understatements or misstatements of amounts. H.B. 1695 amends this section to prohibit stacking under section 231-36, 231-36.4 and 231-36.8. Under the IRC, this type of penalty is generally known as an accuracy related penalty and cannot be stacked with a penalty for erroneous claim for refund or credit. There are no provisions in the IRC which indicate that accuracy related penalties should not be assessed if a person is guilty of certain tax crimes.

Section 231-36, HRS, regarding false and fraudulent statement; aiding and abetting is a criminal statute because the punishment is imposed upon conviction. Section 7206 is the corresponding IRC section to section 231-36, HRS. If it the Committee's intent is to achieve IRC conformity, the Department suggests that the anti-stacking provision be limited to section 231-36.8 under which a civil penalty for erroneous claim for refund or credit may be assessed.

#### Section 3 – Amending § 231-36.8, HRS

As discussed above, since HRS section 231-36 and 231-36.4 are criminal statutes under which civil penalties are not imposed. The Department suggests that section 3 be amended so that the anti-stacking provision is limited to a civil penalty assessed under section 231-36.6. The criminal fines imposed under the criminal statutes are not civil penalties to which anti-stacking provision should apply.

Thank you for the opportunity to provide comments.

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SUBJECT: ADMINISTRATION, Penalty Provisions

BILL NUMBER: SB 1998; HB 1695 (Similar)

INTRODUCED BY: SB by Ige, Kidani, Shimabukoro, Wakai and 4 Democrats; HB by Choy

BRIEF SUMMARY: Amends HRS sections 231-36.4, 231-36.6 and 231-36.8 to prevent the multiple imposition of the penalty provision of 20% on any underpayment that is imposed under HRS section 231-36 (false and fraudulent statements), HRS section 231-36.6 (substantial understatements or misstatements of amounts) or HRS section 231-36.8 (erroneous claim for refund or credit).

EFFECTIVE DATE: Tax years beginning after December 31, 2011

STAFF COMMENTS: Act 166, SLH 2009, established penalties of 20% of the: (1) portion of any underpayment for an understatement of a taxpayer's tax liability; and (2) excessive amount of the filing of a claim for refund or credit in the event of an erroneous claim for refund or credit. While it appears that multiple penalties for more than one violation of the underpayment provisions may be imposed under the state laws, federal laws prohibit the imposition of more than one penalty even though they are attributable to more than one violation. Adoption of this provision would allow taxpayers to mitigate their burden of an underpayment penalty similar to the federal treatment of a like infraction.

Digested 1/25/12

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**THE SENATE  
THE TWENTY-SIXTH LEGISLATURE  
REGULAR SESSION OF 2012**

**COMMITTEE ON WAYS AND MEANS  
Hearing Date: March 20, 2012  
Time: 9:00 AM  
Testimony on H.B. 1695  
(Relating to Taxation)**

Chair Ige, Vice-Chair Kidani, and members of the Committee, thank you for the opportunity to testify **in support of House Bill 1695**.

This purpose of this bill is to incorporate certain language in Internal Revenue Code (“IRC”) that prevent one penalty from stacking on top of another penalty into the analogous provisions in Hawaii law.

In 2009, several new sections were added to Hawaii Revised Statutes. The two involved in this bill are Hawaii Revised Statute (“HRS”) § 231-36.6 and HRS §231-36.8. HRS § 231-36.6 is an accuracy related penalty and imposes a twenty percent (20%) penalty for substantial understatement or misstatement of tax provisions. It is based on IRC § 6662. HRS § 231-36.8, imposes a twenty percent (20%) penalty for erroneous refund or credit claims. HRS § 231-36.8 is based on IRC § 6676.

Under the current law, the twenty percent (20%) penalty for substantial understatement or misstatement of tax provisions in Hawaii Revised Statute (“HRS”) § 231-36.6 and the twenty percent (20%) penalty for erroneous refund claims in HRS § 231-36.8 could stack resulting in a penalty of forty percent (40%) even though they arose out of the same facts. Such stacking is not permitted under the analogous provisions in the IRC.<sup>1</sup>

An example of such unfairness might occur when an auditor determines that a claim for the Research and Development under HRS § 235.110.91 is erroneous. The auditor disallows the claim and assesses a penalty under HRS § 231-36.8. Because the claim has been disallowed, the taxpayer has underpaid his/her taxes. The auditor then assesses a 20% penalty for a substantial understatement. Under the IRC and Treasury Regulations, only one penalty could be assessed.

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<sup>1</sup> IRS Penalty Handbook Section 5 Related Return Penalties, Section 20.1.5.3.2 paragraph 6 provides “Stacking of IRC 6662, IRC 6663, IRC 6662A, and IRC 6676 penalties is not permitted. The Maximum amount of the IRC 6662 penalty imposed on a portion of the underpayment of the tax is 20 percent . . . of that portion of the underpayment, even if that portion of the underpayment is attributable to more than one type of misconduct under IRC 6662.”

## **IRC § 6662 - Accuracy-Related Penalty - The Foundation for HRS § 231-36.6**

### Historical Background on Penalty:

Prior to 1989, separate sections within the Internal Revenue Code imposed penalties on understatements of tax due to negligence, substantial understatements of tax liability, valuation overstatements for income tax purposes, overstatements of pension liabilities, and valuation understatements for purposes of estate or gift taxes. These individual penalties could be applied cumulatively, so that a single transaction could be subject to multiple penalties.

To improve the coordination of these penalties and to prevent the stacking of these penalties, Congress repealed these separate penalty provisions and combined them into a single accuracy-related penalty under s IRC § 6662(a).

IRC § 6662(a) imposes a 20-percent penalty on the portion of an underpayment of tax attributable to:

- Negligence or intentional disregard of rules or regulations;
- A substantial understatement of income tax;
- A substantial valuation overstatement;
- A substantial overstatement of pension liabilities; or
- A substantial estate or gift tax valuation understatement

The penalty applies only to that portion of the underpayment attributable to the particular underpayment is 20%.

## **IRC § 6676 - Erroneous Claim for Refund or Credit - The Foundation for HRS § 231-36.8**

### Historical Background on Penalty:

Small Business and Work Opportunity Tax Act of 2007 Small Business and Work Opportunity Tax Act of 2007 (the Act) created new penalty risks for both the taxpayer and the preparer with respect to claims for refund, including amended returns claiming a refund.

As background, a taxpayer can be subject to a penalty if the taxpayer's tax return fails to satisfy the standards of care set forth in IRC § 6662 and there was an underpayment of the taxpayer's tax liability.

In general, under the new rule, taxpayers can be subject to a 20% penalty on refund claims if the IRS denies a refund claim and there is no reasonable basis for the claim.

### Details of Penalty:

IRC § 6676 provides a penalty for erroneous refund claims with respect to income taxes.

Under this provision, a penalty equal to 20 percent of the refund that is "excessive" may be imposed if the refund claim is denied and there was no reasonable basis for the portion of the claim that is "excessive" (i.e., the position was merely arguable; less than 15-20 percent likelihood of success). The portion of a refund claim that exceeds the allowable amount of the refund is considered excessive. **The IRC § 6676 penalty does not apply if the IRC § 6662 penalty applies.**

Related Penalties:

**As described above, this penalty would generally apply in cases where the IRC § 6662 penalty may have applied but for the fact that there is no underpayment. Pursuant to IRC § 6676(c), the penalty will not apply to any portion of the excessive amount which is subject to the IRC § 6662 penalty.**

IRC § 6676(c) provides:

(c) Coordination with other penalties.

This section shall not apply to any portion of the excessive amount of a claim for refund or credit which is subject to a penalty imposed under part II of subchapter A of chapter 68.

The penalties imposed under Part II of Subchapter A of Chapter 68 are § 6662, § 6662A - Accuracy-Related Penalty on Understatements With Respect to Reportable Transaction; § 6663 - Civil Fraud, and §6664 which provides that no penalty shall be imposed under IRC § 6662 with respect to any portion of an underpayment of tax upon a showing by the taxpayer that there was reasonable cause and the taxpayer acted in good faith.

Why Hawaii's Tax Code Should be Amended

In 2009, the Department testified that "[f]undamentally, this measure is about fairness in the administration [of taxes]. . .". The Department incorporated the provisions of the IRC into Hawaii law and uses regulations for to those provisions to administer the law. However, the anti-stacking provisions were not incorporated into the Hawaii's law. It is not fair to assess (stack) multiple penalties for the same factual situation which is something that is not allowed in the IRC. I respectfully ask this Committee pass this measure and to provide the fairness that the Department claimed was in the original bill. Taxpayers deserve nothing less.

Thank you for the opportunity to testify.

Respectfully,



Peter L. Fritz