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To: The Honorable Jill N. Tokuda, Chair
and Members of the Senate Committee on Ways and Means

Date: Thursday, February 4, 2016
Time: 9:00 A.M.
Place: Conference Room 211, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: S.B. 2925, Relating to the Tax Adjustments.

The Department of Taxation (Department) strongly supports this Administration measure and provides the following comments for your consideration.

S.B. 2925 clarifies that the statute of limitations to claim a refund cannot be extended by filing an amended federal return. Specifically, this measure provides that when a federal tax return is changed, corrected, or adjusted by the Internal Revenue Service (IRS) and such change, correction, or adjustment would result in a State tax refund, no refund claim is allowable, other than the decrease in state tax directly resulting from such change, correction, or adjustment, unless the taxpayer has filed a request for refund within the time limits established by section 235-111, Hawaii Revised Statutes (HRS). The measure takes effect upon approval.

Generally, a claim for refund must be filed within three years from the time the return was filed or from the due date prescribed for the filing of the return, or within two years from the time the tax was paid, whichever is later. As currently enacted, section 235-111(b), HRS, would seem to allow a taxpayer who has failed to timely file a refund claim with the Department to extend the statute of limitations by merely submitting an amended federal tax return, even if no substantive changes are made to the return and irrespective of whether such return is actually accepted by the IRS. The Department believes that this measure will provide clarity for taxpayers and the Department.

Thank you for the opportunity to provide testimony in support of S.B 2925.

TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Tax Adjustments

BILL NUMBER: SB 2925; HB 2396 (Identical)

INTRODUCED BY: SB by Kouchi by request; HB by Souki by request

EXECUTIVE SUMMARY: If a taxpayer files an amended return or is adjusted by IRS, the taxpayer is required to file a corresponding State return reflecting the adjustment, and an extra year is allowed for the Department to assess additional tax or for the taxpayer to request a refund. During this “bonus time,” the bill basically gives the Department the right to assess more tax, and denies the taxpayer the right to a refund if the federal adjustment was taxpayer favorable. This is unfair.

BRIEF SUMMARY: Amends HRS section 235-101(b), which is the statute reopening the statute of limitations in the case of federal amended returns or federal adjustments, to say that a tax refund owed to the taxpayer as a result of a federal tax change, correction, or adjustment shall not be allowed unless the refund request is timely under the normal three-year period in HRS section 235-111; furthermore, such refund will be limited to the decrease in state tax resulting from such change, correction, or adjustment.

EFFECTIVE DATE: Upon approval

STAFF COMMENTS: This measure was submitted by the Department of Taxation as TAX-05 (16). If an amended federal return is filed, or the amount of federal tax is adjusted by IRS, then the law requires the affected taxpayer to file an amended State return reflecting the changes, and the statute of limitations on assessment or refund, even if it has previously expired, is reopened for another year following the federal change. The most common scenario is where IRS audits a federal return, sends a report of the adjustment to the State, and the State assesses the taxpayer the additional State tax corresponding to the federal change.

When the State statute of limitations is reopened, the statute as it now exists limits the assessment and refund claims to those “attributable to this report,” so assessments or refunds unrelated to the issues germane to the federal change are already excluded.

The proposed amended language appears to be self-contradictory. The first sentence bars refunds unless filed within the normal three-year period, and thus says that the Department can assess more tax but the taxpayer can’t get a refund. The second sentence limits refunds to the “decrease in state tax” resulting from the adjustment unless the refund claim was filed within the normal period. This sentence appears to presume that a refund can be issued even if not filed within the normal period, and in that respect contradicts the first sentence. If passed as is, the first sentence would subsume the second one, leading to an unfair “one-way street.”

Furthermore, there is an additional element injected by the second sentence, the concept of “decrease in state tax.” Suppose a taxpayer files a return showing \$100 in tax liability and \$150 in refundable credits, and receives a refund of \$50. Then, four years later, the IRS adjusts the taxpayer’s income downward such that the amount of State tax owed before credits becomes \$75. The Department could convincingly argue that the taxpayer owed zero state tax before the adjustment, and owed zero state tax after the adjustment, so the second sentence limits the taxpayer’s refund to zero minus zero, or zero. (See, for example, *Rand v. Commissioner*, 141 T.C. 376 (2013), which held that credits cannot reduce the “amount shown as tax” on a return below zero.) This element adds an additional degree of unfairness.

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**Testimony to the Senate Committee on Ways and Means
Thursday, February 4, 2016 at 9:00 A.M.
Conference Room 211, State Capitol**

RE: SENATE BILL 2925 RELATING TO TAX ADJUSTMENTS

Chair Tokuda, Vice Chair Dela Cruz, and Members of the Committee:

The Chamber of Commerce Hawaii ("The Chamber") **offer comments** on SB 2925, which specifies that taxpayers who file an amended return under section 235-101, Hawaii Revised Statutes, may not claim a refund unless such refund is claimed within the time limits established by section 235-111, Hawaii Revised Statutes.

The Chamber is Hawaii's leading statewide business advocacy organization, representing about 1,000 businesses. Approximately 80% of our members are small businesses with less than 20 employees. As the "Voice of Business" in Hawaii, the organization works on behalf of members and the entire business community to improve the state's economic climate and to foster positive action on issues of common concern.

SB 2925 is confusing and provides some contradictions. The bill addresses situations in which there is a federal tax audit, and what state tax adjustments are permitted following a federal audit. Under HRS 235-101 as currently drafted, for up to one year following the federal audit, the State may require additional payment of tax or the taxpayer may request a refund of tax, depending on the results of the federal audit. This extends the normal statute of limitations in cases where there is a federal audit.

The bill adds two sentences to HRS 235-101. The first sentence entirely prevents taxpayers from making claims for refund outside of the statute of limitations. The second sentence appears to permit taxpayers to make claims for refund (including outside of the statute of limitations), but limits those claims to amounts impacted by the federal audit. In our reading of the bill, the two sentences are directly contradictory.

If it is the intent of the Department to move in the direction of eliminating all claims for refund outside of the statute of limitations we would be in opposition.

Thank you for the opportunity to testify.

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Senate Committee on **WAYS & MEANS**

Thursday Feb. 4, 2016 at 9:00 a.m.
Conference Room 211

Testimony of Ronald I. Heller

In Opposition to Senate Bill 2925 Relating to Tax Adjustments (Refunds based on IRS Adjustments)

Chair Tokuda, Vice-Chair Dela Cruz, and Members of the Committee:

I **oppose** Senate Bill 2925. Frankly, I am appalled that the Department of Taxation would even propose this. It shows an attitude that collecting the maximum possible amount takes precedence over fairness – an attitude that should not represent the way the Department of Taxation thinks or functions.

What this bill does is to convert an IRS audit into a one-sided “heads we win, tails you lose” process at the State level. It would allow the Department of Taxation to assess additional state tax based on an IRS determination, while at the same time prohibiting taxpayers from claiming refunds based on IRS determinations.

IRS audits can sometimes last for years, and result in adjustments that are made after the three-year statute of limitations has expired for state tax purposes. When that happens, there is a window of time for a state income tax adjustment to parallel whatever the IRS did at the federal level. Under current law, it goes both ways – if the IRS adjustment results in greater tax liability, the Department can increase the taxpayer’s Hawaii income tax, but if the if the IRS adjustment results in a reduction of tax liability, the taxpayer can claim a similar reduction in his

Hawaii income tax. In short, if the IRS makes an adjustment to your federal income tax, the state will follow that adjustment, upward or downward.

This bill would change that to a one-way process where your Hawaii tax can go up based on what the IRS finds, but it cannot go down based on what the IRS finds. That amounts to throwing fairness out the window.

As a practical matter, when the IRS makes adjustments in an income tax audit, most of the time those adjustments will be upward in terms of tax liability. Cases where an IRS audit results in a refund to the taxpayer do happen, but they are the exception, not the rule. Obviously, those are cases where the taxpayer has made a mistake and overpaid. There is no legitimate reason to deny a State refund to the taxpayer in those cases.

The Department of Taxation's mission statement says:

Our mission is to administer the tax laws of the State of Hawaii in a consistent, uniform, and fair manner.

This Bill would throw out the part about being fair.

I urge you to reject SB 2925.

Respectfully submitted,



Ronald I. Heller