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To: The Honorable Donovan M. Dela Cruz  
and Members of the Senate Committee on Ways and Means

Date: Tuesday, February 6, 2018  
Time: 10:00 A.M.  
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director  
Department of Taxation

Re: S.B. 2823, Relating to Tax Administration

The Department of Taxation (Department) strongly supports S.B. 2823, an Administration measure, and provides the following comments for the committee's consideration.

H.B. 2823 increases the ceiling on revenues collected by the Department's Special Enforcement Section (SES) that are retained in the Tax Administration Special Fund from \$700,000 to \$1,000,000. The fund is used to pay expenses of staff investigating noncompliance and fraud, especially in transient accommodations tax. The remainder of the revenue collected by SES is swept into the general fund annually. SES is a unique unit within the Department in that it is funded solely through its tax revenue collections. S.B. 2823 is effective upon approval.

SES contributes significantly to the Department's compliance efforts, particularly its efforts at promoting voluntary compliance. Since its inception, SES has consistently generated tax revenue in excess of its budget. In FY 2017, SES generated approximately \$9 for every \$1 expended. These results can be improved upon with the increased budget and expanded workforce that this bill would provide.

Departmental exposure and visibility to the public has an outsized impact on voluntary compliance. At the Department, SES is unique in its level of public exposure and visibility to the business community. With an increased budget and workforce SES will further increase its public profile by conducting more field visits and attending more public events, leading to increased voluntary compliance.

An expanded workforce will also enable SES to better investigate and assess taxpayers who are not voluntarily complying. In FY 2017, SES began using data analytics to identify potential cases, specifically in the transient accommodations industry. The use of data analytics has generated large numbers of potential cases. An expanded workforce will enable SES to

investigate more of these potential cases, leading to increased assessment and collection. In addition, increasing the number of investigations and audits conducted will provide further incentive for voluntary compliance.

Thank you for the opportunity to provide comments.

# TAX FOUNDATION OF HAWAII

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**SUBJECT:** ADMINISTRATION, Increase Limit on Revenues Deposited into Tax Administration Special Fund

**BILL NUMBER:** HB 2396; SB 2823 (Identical)

**INTRODUCED BY:** HB by Saiki by request; SB by Kouchi by request

**EXECUTIVE SUMMARY:** Allows the Department of Taxation to pocket more money that it collects, and to spend it without legislative or other oversight.

**SYNOPSIS:** Amends section 235-20.5, HRS, to provide that all revenues collected by the department of taxation's special enforcement section in excess of \$1 million shall be deposited into the general fund. The previous ceiling was \$700,000.

**EFFECTIVE DATE:** Upon approval.

**STAFF COMMENTS:** This is an administration measure submitted by the department of taxation TAX-03 (18).

In early November 2017, the State Auditor issued Report 17-10, which reviewed special, revolving, and trust funds administered by the Department of Taxation. One of them is the Tax Administration Special Fund, which, although not an area of concern for the auditor, is becoming an all-purpose slush fund for which corrective action is needed.

The Tax Administration Special Fund was established by Act 215 of 2004, one of the major purposes of which was to rein in the High Technology Business Investment Credit, a whopping incentive for the high technology industry and others that was rapidly spiraling out of control. The thought at the time was that because the Department of Taxation was spending a lot of time issuing rulings on the applicability of the credits, the Department would be allowed to charge user fees for the rulings and thereby pay for a few more bodies to review the cases and pump out the rulings. The special fund was enacted for that purpose. Its authorizing statute was placed in the Income Tax Law because the high technology credit was an income tax credit.

In 2009, Act 134 created a special enforcement section within the Department that was primarily targeting "cash economy" transactions, typically those where the buyer pays in cash and the seller "conveniently forgets" to pay General Excise Tax (GET). This Act amended the special fund statute so that whatever the special enforcement section brought in the door, up to \$500,000, would go to the special fund; any more would go to the general fund like most tax collections. The fund was then allowed to pay for the employees in the special enforcement section.

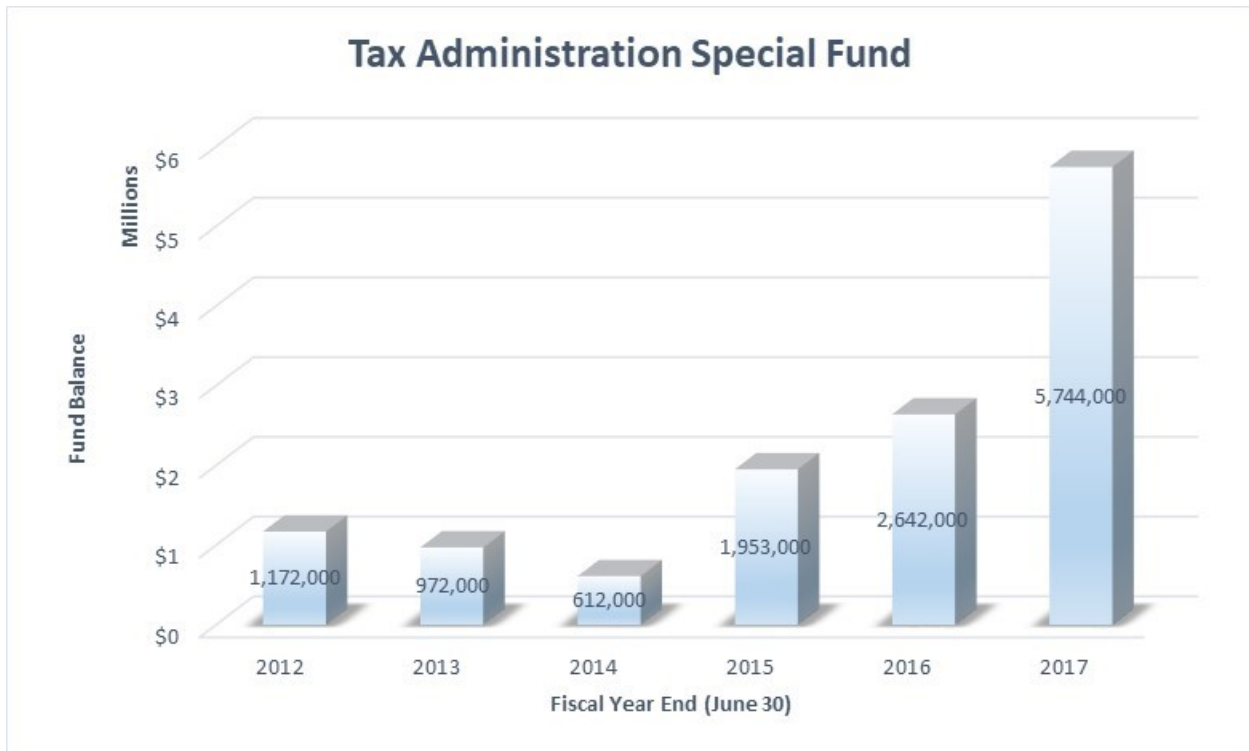
In 2015, Act 204 enacted new compliance requirements aimed at transient vacation rentals, such as bed and breakfast operators who "conveniently forget" to pay both GET and transient

accommodations tax (TAT). The act imposed fines upon those who failed to comply, and allowed those fines to go into the special fund.

At this point, the fund was fed by activity relating to the income tax, the GET, and the TAT, but the statute authorizing the fund remained in the Income Tax Law.

On the expense side, the Department apparently found itself with too much money in the special fund, so it asked the legislature for authority to spend the fund money on taxpayer education programs and publications. That bill breezed through the legislature and became Act 89 of 2014.

Even with this extra spending authority, the fund has ballooned in recent years:



Source: Office of the Auditor, Report 17-10 (2017).

The lion's share of the State's tax revenue goes to the general fund. The expenses of collecting that revenue should therefore be paid by the general fund. Giving any agency a special fund allows it to spend money while bypassing legislative oversight. Moreover, when fines and penalties are channeled directly into a special fund out of which tax collectors are paid, it incentivizes the Department to penalize people to maximize its revenue, when they should be administering the revenue laws equitably and fairly.

For similar reasons, the Foundation raised concerns about a bill sponsored by the Department of Public Safety in 2016 that proposed to scoop any fines raised from violations of the State drug laws. That department wanted to drop those fines into their special fund so they could hire more enforcement personnel. We said that wasn't a good way to fund government operations.

Thankfully, the Conference Committee snipped out that provision from the final version of the bill.

This year, the Department of Labor and Industrial Relations is sponsoring an Administration bill, LBR-01 (18), to pocket the penalties and civil fines it collects, and the Foundation will raise these same issues there as well.

The facts and figures in the Auditor's report highlight these concerns. The Tax Administration Special Fund, originally intended to hold a few hundred thousand dollars, has grown to \$5.7 million in just a few years. Why? Has the bloodlust to collect fines and penalties taken over at the Department? The Department is given statutory powers that can and do ruin businesses and lives, and, under HRS section 662-15(2), the Department is absolutely immune from liability for erroneous, intentional, or even fraudulent misuse of those powers. So, there are very good reasons why we need the Department to act responsibly. We need to give the Department adequate resources to do its job, but a slush fund should be out of the question.

Digested 1/30/2018