DAVID Y. IGE
GOVERNOR

JOSH GREEN M.D.
LT. GOVERNOR

ISAAC W. CHOY
DIRECTOR OF TAXATION

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1540
FAX NO: (808) 587-1560

To: The Honorable Sean Quinlan, Chair;
The Honorable Daniel Holt, Vice Chair;
and Members of the House Committee on Economic Development

From: Isaac W. Choy, Director
Department of Taxation

Date: March 17, 2021
Time: 10:30 A.M.
Place: Via Video Conference, State Capitol

Re: S.B. 1198, S.D. 2, Relating to Tax Administration

The Department of Taxation (Department) strongly supports S.B. 1198, S.D. 2, an Administration measure. This measure has a defective effective date of July 1, 2050.

S.B. 1198, S.D. 2, makes the following amendments to Hawaii Revised Statutes (HRS) chapters 231, 232, and 235 to improve general tax administration:

1. Authorizes the Department to require electronic filing for certain partnership, S corporations, and individuals. S.B. 1198, S.D. 2, authorizes the Department to require:

   - Partnerships and S-corporations to file electronically if their gross income exceeds $250,000 for the taxable year; and
   - Individuals to file electronically if their federal adjusted gross income, as reported on their Hawaii income tax return, exceeds $100,000 for the taxable year.

   The Department notes that electronic filing improves accuracy and efficiency. The Department believes the bill will only affect taxpayers with the ability and sophistication to easily comply with the electronic filing requirement. In addition, these taxpayers are likely already required to file general excise tax returns electronically.

2. Amends the penalty for failure to file electronically to allow the Department, by administrative rule, to determine the penalty if there is no tax shown on the improperly filed return or document.

   This provision will allow the Department some flexibility to determine the penalty in situations where there is no tax liability shown on the return. Currently, the penalty is a percentage of the tax required to be shown on the return. Thus, if no tax must be reported, no

penalty can be imposed. It is important to note that the reasonable cause exception to the penalty is still available when applicable.

3. Requires tax return preparers to file electronically if the preparer prepares more than ten returns of the same tax type in the calendar year and imposes a penalty for failure to do so.

   This provision will help increase electronic filing and improve accuracy and efficiency. The penalty on tax return preparers for failing to file electronically is $50 per failure and includes an exception to the penalty for reasonable cause. This electronic filing requirement for return preparers matches the requirements imposed by the Internal Revenue Service.

4. Streamlines the rules for filing and payment of taxes by electronic funds transfer.

   The Department has been granted separate statutory authority (HRS section 231-8.5) to require electronic filing since the enactment of HRS section 231-9.9. Therefore, the language authorizing mandatory electronic filing in HRS section 231-9.9 is redundant.

   Under current law taxpayers are penalized under HRS section 231-9.9 for failure to pay by EFT and for paying late. Because HRS title 14 contains other penalties for late payment, this measure amends the EFT penalty so that it is only imposed when payment is not made by EFT when required to do so.

   In regard to EFT, S.B. 1198, S.D. 2, also clarifies the information that the Department reports to the Legislature each year on electronic fund transfer penalties and assessments.

5. Repeals the fee of $5 for a certified copy of a tax clearance.

   The Department no longer offers certified copies of tax clearances so the statute authorizing the Department to charge for them is no longer necessary.

6. Authorizes the Department to make limited disclosures of liquor licensees' tax compliance information directly to the license issuing agency.

   The statute that requires a tax clearance to be issued prior to issuing a liquor license must be updated to reflect current administrative processes. This authorization will leverage functionality in our new tax system to streamline the tax clearance process, which benefits both taxpayers and government.

   Alternately, because a number of other government agencies require a tax clearance for various purposes, a separate section could be added to enable the Department to provide this information directly to partner agencies.

7. Clarifies the interest rate the State must pay on amounts paid pending appeal that are subsequently determined to be owed to the taxpayer.

Under current law, the interest rate was calculated by reference to Internal Revenue Code (IRC) section 6621(a) as of January 1, 2010. This reference and the date of January 1, 2010 has led to confusion as to how the rate is calculated. This bill repeals the reference to the IRC and defines the interest rate as a fixed rate, consistent with the IRC. The fixed rate proposed is the rate that would be calculated under the Department's interpretation of current law, thus, there is no substantive change in the interest rate.

8. Amends HRS section 235-20.5 to expand the usage of the funds in the tax administration special fund.

The Department respectfully requests that this measure be amended to be effective upon its approval, with the exception of Section 2 which should become effective on January 1, 2022. Thank you for the opportunity to provide testimony in strong support of this measure.

LEGISLATIVE TAX BILL SERVICE

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: ADMINISTRATION, E-filing requirements and penalty, Clearances

BILL NUMBER: SB 1198, SD2

INTRODUCED BY: Senate Committee on Commerce and Consumer Protection

EXECUTIVE SUMMARY: Allows the Department of Taxation to mandate the electronic filing of partnership and S-corporation returns if the taxpayer's gross receipts exceed $250,000 and individual tax returns if the federal adjusted gross income, as shown on the taxpayer's Hawaii return, exceeds $100,000. Requires certain tax return preparers to file returns electronically. Amends the rules for electronic funds transfer to remove the authorization to require electronic funds transfer or electronic filing if the federal government required that person to file or pay electronically. Requires electronic funds transfers for tax return preparers and any person subject to mandatory electronic filing. Removes the timeliness requirement from the electronic funds transfer penalty. Removes the authority of the department to charge for certified copies of tax clearances. Amends the statute that mandates tax clearances for liquor license holders. Clarifies the interest rate for payments made to taxpayers out of the litigated claims fund. Expands the permissible uses of the tax administration special fund.

SYNOPSIS: Amends section 231-8.5, HRS, to allow the Department to also require electronic filing of: (1) partnerships whose gross income exceeds $250,000, (2) S corporations whose gross income exceeds $250,000, and (3) individuals whose federal AGI exceeds $100,000. Requires all tax preparers to file electronically for any returns for which the Department provides an electronic filing option and if the preparer reasonably expects to prepare more than 10 returns of that same tax type in a calendar year. Provides for penalties of $50 each against the preparer and client for noncompliance.

Also provides that the Department by rule may provide for a penalty for failure to e-file even if the tax required to be shown on the return is zero.

Amends section 231-9.9, HRS, to allow the Department to require electronic remittance when the return is prepared by a tax preparer and is required to be e-filed under section 231-8.5 as amended. The 2% penalty is amended to apply only to failure to remit electronically because the penalty for failure to e-file is separate. Deletes the requirement that the Department report to the legislature each of the penalties assessed, but just requires the total.

Amends section 231-10.8, HRS, to delete the Department's authority to charge $5 for certified copies of tax clearances.

Makes technical amendments to section 231-28, HRS, relating to the tax clearance requirement for liquor licensees.

Amends section 232-24, HRS, to provide that taxes paid pending appeal bear interest at:

(1) For corporations, 3 per cent;

(2) For corporations whose overpayments exceed $10,000, 1.5 per cent; and

(3) For all other taxpayers, 4 per cent.

Amends section 235-20.5, HRS, to permit the moneys in the tax administration fund to be used for the following three additional purposes:

(1) Funding information technology and related positions that are exempt from chapter 76, HRS (civil service);
(2) Funding the operations of the criminal investigation section, including support staff positions; and
(3) Funding the operations of the administrative rules office.

EFFECTIVE DATE: 7/1/2050.

STAFF COMMENTS: This is an Administration bill sponsored by the Department of Taxation and identified as TAX-04 (21).

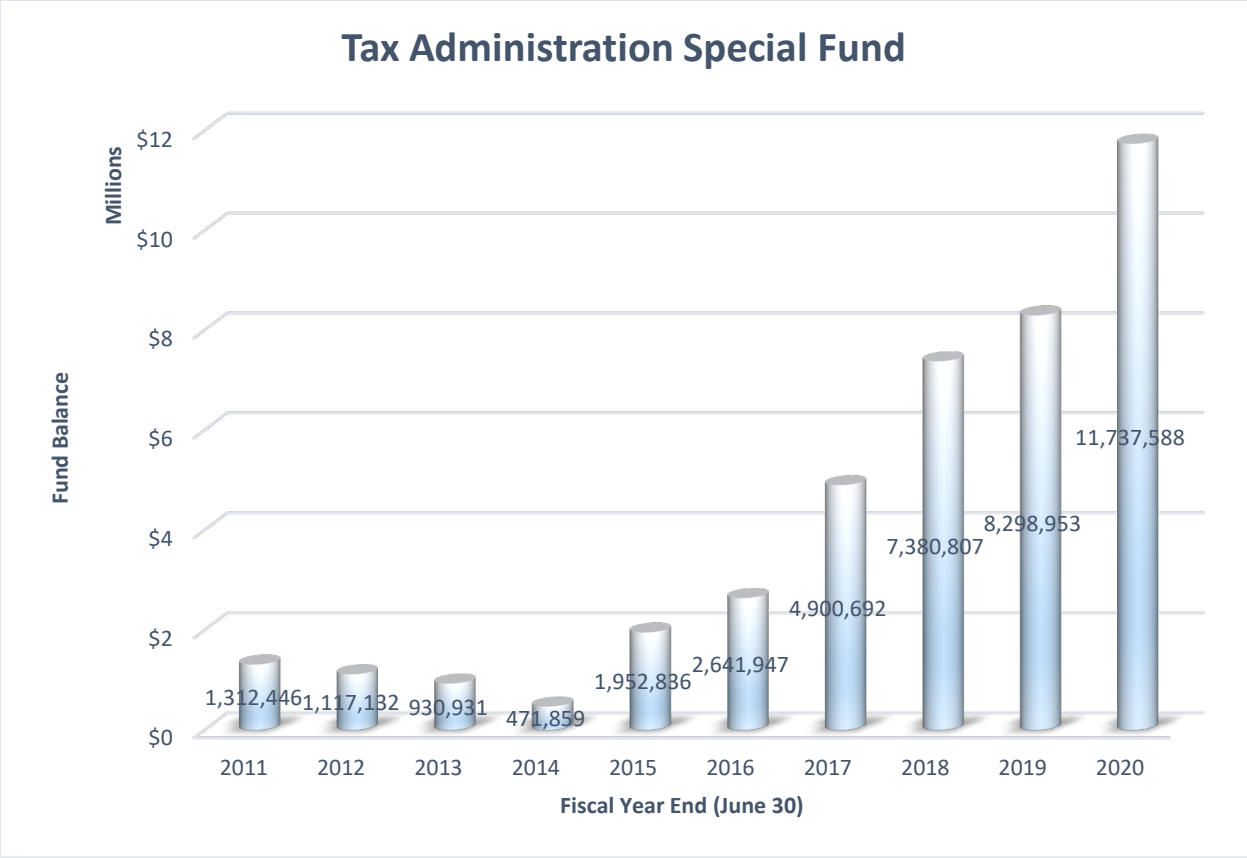
The amendments proposed by DOTAX do seem to be consistent with the national trend toward e-filing and e-payment, and add clarity to tax administration.

We suggest that if the legislature wishes to impose a penalty for failing to e-file when no tax is due on the return (proposed section 231-8.5(f)), that it either specify the amount or specify standards to guide DOTAX in setting the penalty, rather than leaving DOTAX with unbridled discretion to set the penalty by administrative rule.

We are concerned about the proposed amendments to section 235-20.5, HRS. For the reasons stated in the Foundation's article from 2017, reprinted below, the Tax Administration Special Fund seems to be straying from its initial goals and is becoming an all-purpose slush fund. Even with substantial transfers to the general fund, it has absolutely exploded, having an eight-figure balance at the end of FY 2020. If the fund is there because the Department charges a user fee for tax rulings and collects money to support a few extra attorneys and specialists to write those tax rulings, that's one thing. If the fund is scooping fines and penalties (which the statutes such as 231-39(b), HRS, define as additional taxes) and using that money to fund general Department operations, however, we believe it is a misuse of a special fund.

Section 37-62, HRS, defines a special fund as one that is "dedicated or set aside by law for a specified object or purpose, but excluding revolving funds and trust funds." According to the State's *Accounting Manual*, special funds are funds used to account for revenues earmarked for particular purposes and from which expenditures are made for those purposes. Examples of special funds include the Captive Insurance Administrative Fund, which is funded by fees paid by insurers that support the State's Captive Insurance Program, and the Wireless Enhanced 911 Fund. The Wireless Enhanced 911 Fund receives surcharges from wireless phone users for the upgrade of the 911 emergency system.

What we have, however, is this:



Source: Department of Budget & Finance, Reports on Non-General Fund Information

The Tax Administration Slush Fund

[Published by the Tax Foundation of Hawaii on Dec. 4, 2017]

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 bill 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:

[Chart omitted. Please see chart with current data above.]

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. (Special funds are also charged for central administrative expenses, as we described in a previous article.) 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.

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 3/15/2021