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STATE OF HAWAII
DEPARTMENT OF TAXATION

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DEPUTY DIRECTOR

**TESTIMONY OF
GARY S. SUGANUMA, DIRECTOR OF TAXATION**

TESTIMONY ON THE FOLLOWING MEASURE:
S.B. No. 3176, S.D. 1, Relating to Tax Enforcement.

BEFORE THE:
House Committee on Judiciary & Hawaiian Affairs

DATE: Tuesday, March 12, 2024
TIME: 2:00 p.m.
LOCATION: State Capitol, Room 325

Chair Tarnas, Vice-Chair Takayama, and Members of the Committee:

The Department of Taxation ("Department") strongly supports S.B. 3176, S.D. 1, an Administration measure, and offers the following comments for your consideration.

S.B. 3176, S.D. 1 amends Hawaii Revised Statutes (HRS) sections 235-108, which governs audit procedures for State net income tax, 236E-18.5, which governs audit procedures for the State's estate and generation-skipping transfer tax, and 237-39, which governs audit procedures for the State's general excise tax. The bill makes two key amendments: (1) By imposing a deadline for taxpayers under audit to respond to a written demand from the Department for records; and (2) prohibiting taxpayers who fail to comply with the Department's written demand for records from introducing those records during a tax appeal unless the failure is due to reasonable cause and not neglect or refusal.

The bill is effective upon approval and applies to taxable years and transfers after December 31, 2023.

Deadline to Comply with Demand for Records During Audit

Section 231-35, HRS, provides that any person required to supply any information under title 14 who willfully fails to supply the information "at the time or times

required by law" shall be guilty of a misdemeanor.

Although taxpayers are required to keep account and transaction records and permit the Department to examine those records, there is currently no statutory deadline for taxpayers to comply with the Department's information and document requests during an audit. This bill clarifies the "time required by law" for taxpayers to supply information requested by providing a statutory deadline of 30 business days after a written demand is mailed, subject to an extension as determined by the Director. This amendment will assist taxpayers in understanding their obligations during an audit and assist the Department with obtaining information necessary for the audit in a timely manner.

Consequence for Fail to Comply With Demand for Records During Audit

As noted above, this bill prohibits taxpayers from introducing those records during a tax appeal if not initially produced in response to the Department's written demand for records during an audit within 30 business days after a written demand is mailed, unless the failure is due to reasonable cause and not neglect or refusal. The deadline is also subject to an extension as determined by the Director.

Many taxpayers ignore the Department's requests for information or refuse to permit the Department to examine records during an audit. This requires the Department to expend time and resources obtaining information from third parties to prepare an assessment based on the best available information. However, after a final assessment is issued and the audit is closed, taxpayers produce the records for the first time during a tax appeal.

Appeals with disputes that could have been resolved prior to assessment create significant burdens for the Department, and the Judiciary, which hears the tax appeal, and the Department of the Attorney General, which represents the Department in tax appeals. Incentivizing taxpayers to be more responsive and forthcoming during audits will improve tax compliance and tax administration while promoting judicial economy and efficiency.

Thank you for the opportunity to provide testimony in support of this important measure.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 305

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, ESTATE, GENERAL EXCISE, Tax Enforcement; Audits; Time to Respond; Failure to Respond; Appeals

BILL NUMBER: SB 3176 SD 1

INTRODUCED BY: Senate Committees on Ways and Means and Judiciary

EXECUTIVE SUMMARY: Provides deadlines for taxpayers under audit to comply with demands to produce documents and evidence. Requires the tax appeal court to preclude documents or information not produced pursuant to a demand from being introduced in evidence in a tax appeal or action under section 40-35 unless the failure was due to reasonable cause and not neglect or refusal.

SYNOPSIS: Amends section 235-108, HRS, to require that any person liable for any tax imposed under the Income Tax Law or for the collection or deduction thereof at the source shall produce all account books, bank books, bank statements, records, vouchers, copies of federal tax returns, and any and all other documents and evidence relevant to the determination of the income or wages as required to be returned under this chapter within thirty business days after a written demand is mailed to that person by the department, or as soon thereafter as the director may deem reasonable under the circumstances. Any person who fails to produce documents or evidence as provided in this subsection shall be prohibited from introducing the documents or matters in evidence, or otherwise relying upon or utilizing said documents or matters, in any tax appeal or action under section 40-35 arising from the audit in which the documents or matters were demanded, unless it is shown that the failure is due to reasonable cause and not neglect or refusal.

Amends section 236E-18.5, HRS, to add a substantially similar provision to the Estate and Generation-Skipping Tax Law.

Amends section 237-39, HRS, to add a substantially similar provision to the General Excise Tax Law.

EFFECTIVE DATE: Upon approval; provided that Sections 1 and 3 shall apply to taxable years beginning after December 31, 2023; and Section 2 shall apply to decedents dying and taxable transfers occurring after December 31, 2023.

STAFF COMMENTS: This is an Administration bill sponsored by the Department of Taxation and designated TAX-04 (24).

There appears to be a separation of powers issue here because it purports to direct the courts that evidence and documentation that is not provided timely (in the Department's opinion) is not to be considered in any tax appeal or payment under protest suit. The courts, however, have their own powers to sanction parties who do not cooperate with discovery rules without just cause,

including the power to exclude evidence. We note that although the summary of this bill states that it “authorizes” the tax appeal court to preclude documents or information, the bill text says otherwise: that the taxpayer “shall be prohibited” from introducing the documents in evidence or otherwise relying on them.

The 30-business-day deadline specified in the bill, furthermore, is arbitrary. It will take a taxpayer more time to respond to a letter containing 100 requests for documents and information that is likely to produce 100,000 pages of information than a letter containing 5 requests for documents and information that is likely to produce 10 pages of information. Yet 30 days is the deadline to respond to both requests. An arbitrary 30-day rule provided in the bill perhaps would be more convenient for the Department, but it may not advance justice and might not inspire confidence that the Department is applying the tax laws fairly and lawfully.

We also question why “refusal” precludes a finding of reasonable cause to produce a document. There may be good reasons why a document is intentionally withheld, such as if it contains legally privileged or commercially sensitive information. The courts can issue appropriate protective orders restricting further disclosure of such information, but the Department has no such power.

Next, the courts have a mechanism to make sure that discovery requests are relevant and not overly ambiguous. The system proposed in this bill has no safeguards against requests objectionable on those (or, for that matter, any other legally recognized) grounds.

Finally, auditors believing that their requests were not properly responded to are not without remedies. Auditors can, and often do, make assessments based on “best available information” that the taxpayer has the burden to disprove on appeal. At that point, taxpayers that were previously reluctant to dive into musty old boxes or clamber into cobweb-decorated attics to fish out large quantities of information of questionable relevance that were demanded by the auditor would probably be willing to open those boxes and climb into those attics to come up with their case on appeal. Although it may be irritating to auditors to see evidence previously requested but not provided miraculously appear on appeal, it appears to us to be partly a function of human nature—motivation is more concrete and pressing when an appeal looms—and partly a function of the breadth or ambiguity of the auditor’s document requests.

In any event, the only difference between the Senate Bill now before this Committee and its House counterpart, HB 2487, that was deferred by this Committee on February 6, is the arbitrary response period, which Senate Ways and Means lengthened from 20 days to 30 business days.

Digested: 3/9/2024



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March 12, 2024

Representative David Tarnas, Chair
Representative Gregg Takayama, Vice Chair
House Committee on Judiciary & Hawaiian Affairs
Hawai'i State Legislature

Via E-mail

Re: COST Opposes S.B. 3176, Relating to Tax Enforcement

Dear Chair Tarnas, Vice Chair Takayama, and Members of the Committee:

On behalf of the Council On State Taxation (COST), I am writing to express opposition to S.B. 3176, which unduly penalizes and burdens taxpayers. Senate Bill 3176, as amended, would require a taxpayer under a tax audit to produce all documents and evidence relevant to the determination of income or wages within 30 days after a written demand is mailed to the taxpayer by the Department of Taxation (Department). If a taxpayer fails to produce all documents or evidence within the prescribed 30 days, then the taxpayer is prohibited from introducing or relying on such documents or evidence in any future tax appeal or action, unless the taxpayer can show that the failure was due to reasonable cause.

This bill unreasonably and arbitrarily penalizes all taxpayers in a manner that is incongruent with reasonable audit and assessment processes, and it does not provide fair, efficient, and customer-focused tax administration.

About COST

COST is a nonprofit trade association based in Washington, DC. COST was formed in 1969 as an advisory committee to the Council of State Chambers of Commerce and today has an independent membership of approximately 500 major corporations engaged in interstate and international business. COST's objective is to preserve and promote the equitable and nondiscriminatory state and local taxation of multijurisdictional business entities. Many COST members have operations in Hawai'i that would be negatively impacted by this legislation.

S.B. 3176 Does Not Promote Fair, Efficient, and Customer-Focused Tax Administration

The COST Board of Directors adopted a formal policy statement supporting fair, efficient, and customer-focused tax administration as follows:

Fair, efficient and customer-focused tax administration is critical to the effectiveness of our voluntary system of tax compliance. A burdensome,

*unfair, or otherwise biased administrative system negatively impacts tax compliance and hinders economic competitiveness.*¹

Senate Bill 3176 does not provide taxpayers with enough time to produce documents and evidence during an audit. Although S.B. 3176 may be convenient for the Department, the bill does not promote fairness, accuracy, compliance, transparency, or efficiency in the audit process. It does not ensure that both taxpayers and the Department can participate in the audit process in a thorough, efficient, and respectful manner.

Taxpayers need adequate time to gather and organize necessary documents and evidence to support their tax returns and filing positions. It is imperative to give taxpayers a reasonable opportunity to present their case. Further, rushing taxpayers in such a manner will likely produce incomplete or inaccurate information, which creates inefficiencies in the audit process.

This bill is also inconsistent with practical considerations. It is already difficult to produce data sets in specific formats requested by the Department. Many taxpayers also maintain records in various formats and locations, requiring time to compile and review. Moreover, there are other legal and regulatory obligations that taxpayers (and the Department) need to be sensitive towards. Producing certain documents as part of complying with the Department's request, may infringe on taxpayers' legal rights that are not associated with audits (e.g., trade secret protections) or may cause taxpayers to violate their other regulatory obligations (e.g., consumer data protection). Failing to provide taxpayers adequate time to assess and evaluate the circumstances runs the risk of infringing on taxpayers' legal rights and/or exposing taxpayers to undue damage and other legal challenges. These challenges are heightened for taxpayers with broader mixes of taxes and fees they are obliged to comply with (e.g., industry-specific taxes).

Failure to comply with the bill's demands unreasonably penalizes all taxpayers in future tax appeals in a manner that diminishes transparency and trust in the audit process and Hawai'i's tax administration.

Conclusion

Fair, efficient and customer-focused tax administration is fundamental to a state tax system. Senate Bill 3176, however, is contrary to this fundamental principle of good tax governance. For the foregoing reasons, we respectfully urge the Committee to vote "no" on S.B. 3176.

Respectfully,



Stephanie T. Do

cc: COST Board of Directors
Patrick J. Reynolds, COST President & Executive Director

¹ COST, *Fair, Efficient, and Customer-Focused Tax Administration*, <https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-policy-positions/fair-efficient-and-customer-focused-tax-administration---revised-april-2023---final.pdf> (last visited Mar. 10, 2024).

SB-3176-SD-1

Submitted on: 3/8/2024 11:11:40 AM

Testimony for JHA on 3/12/2024 2:00:00 PM

Submitted By	Organization	Testifier Position	Testify
Ron Heller	Individual	Oppose	Written Testimony Only

Comments:

I have more than 40 years of professional experience in dealing with Hawaii taxes. I oppose SB3176 SD1 because it is unnecessary, it will have excessively harsh consequences for taxpayers, and it invades the powers of the courts to determine what is, or is not, admissible evidence in a court case.

It is unnecessary because the Department of Taxation already has a very powerful weapon at its disposal to use when a taxpayer is uncooperative: the power to make an assessment that is legally presumed to be correct. If a taxpayer fails to provide adequate and timely information in a tax audit, the Department can simply decide the issues against the taxpayer, and issue a final assessment. That final assessment is presumed to be correct, unless and until the taxpayer proves otherwise.

This bill would have the unduly harsh consequence of tying the taxpayer's hands in a challenge to a final assessment. Often, taxpayers do not have perfect records; sometimes they receive bad advice from the people they rely upon, sometimes taxpayers simply need more time to figure things out. This bill would penalize any taxpayer who cannot give prompt and complete answers to whatever questions the Department may ask.

This may be a problem for taxpayers from the smallest "Mom & Pop" businesses, who often struggle with understanding tax issues, to the largest multi-national corporations, who may have very extensive and complicated business operations. Either way, setting an arbitrary "one-size-fits-all" 30-day time frame is a problem.

Finally, in a court case, the court should be able to decide what is, or is not proper and admissible evidence. If the Department want to argue that certain evidence should be excluded, the Department is free to make that argument. There is no need for, and no justification for, legislation to take away the power of the court to decide that question based on the specific facts of each case.

I would be happy to address any questions that the Committee may wish to ask me.



March 8, 2024

COMMITTEE ON JUDICIARY & HAWAIIAN AFFAIRS

Rep. David A. Tarnas, Chair
Rep. Gregg Takayama, Vice Chair

Re: **SB3176 SD1** aka **HB2487 Relating to Tax Enforcement**

Hearing Date: 3/12/2024, 2:00 P.M.

Dear Chair Tarnas, Vice-Chair Takayama & Honorable Committee Members:

As a licensed attorney practicing for thirty years in tax controversies, I strongly oppose Senate Bill 3176 SD 1 aka House Bill 2487 for multiple reasons. It's an overwhelmingly one-sided response to a minor problem. This bill should be deferred.

The Department of Taxation is concerned about examinations that are concluded, but then the Taxpayer files an Appeal and produces documents which indicate that the Assessment is incorrect and, as a result, the Department cancels the Assessment.

Somehow, this is a "bad" result, presumably because the Department has "wasted" its time and effort in preparing the Assessment. In my mind, ***the purpose of an audit or an Appeal is to determine the correct amount of tax.*** It is not a process to generate tax bills in excess of the correct amount because the Taxpayer did not strictly comply with the procedural requirements.

The appropriate response to the failure to respond to a document request is the imposition of a **monetary penalty that reflects the expense to the Department of Taxation of preparing an Assessment that is later reversed.** If a Tax Returns Examiner is paid \$27-32/hour, and spends 5 hours of time on an assessment¹, generously adding some time for supervisory, mailing and system costs, an **appropriate fine** for situations where the Taxpayer prevailed in a Tax Appeal Court Appeal or Payment Under Protest procedure is in **the range of \$500.**

The disparity between the ramifications of this measure to taxpayers and the actual costs to the Department of the conduct complained of are unacceptably large for this to be good law or policy.

/s/ Richard McClellan

I have attached my prior testimony to this submission for your reference.

¹ This is an assessment where the Taxpayer does not furnish the documents, after all.



February 2, 2024

COMMITTEE ON JUDICIARY & HAWAIIAN AFFAIRS

Rep. David A. Tarnas, Chair
Rep. Gregg Takayama, Vice Chair

COMMITTEE ON HEALTH & HOMELESSNESS

Rep. Della Au Belatti, Chair
Rep. Jenna Takenouchi, Vice Chair

Re: **HB2487 Relating to Tax Enforcement**

Hearing Date: 2/6/2024, 2:00 P.M.

Dear Chairs Tarnas and Au Bellati, Vice-Chairs Takayama and Takenouchi, & Honorable Committee Members:

As a licensed attorney practicing for thirty years in tax controversies, I strongly oppose House Bill 2487 for multiple reasons. As some background, there are probably dozens of Tax Appeals from the Department of Taxation each year and, at most, a handful of Payment Under Protest actions.

This bill unduly elevates administrative convenience over substance and would make terrible oversights and injustices utterly unable to be corrected by a Court. In addition, it would transform audits in a way that would ultimately make the Department of Taxation less productive.

The prospect of a person not being credited with their wage withholding, paid by their employer to the Department, because they did not comply with a letter requesting a copy of their W-2 within twenty days is truly shocking.

Yet, that is exactly what this bill is asking you to authorize.

The prospect of a person not being credited with their cost basis on the sale of real property because they did not comply with a letter requesting that they furnish an escrow closing statement from twenty or thirty years prior (when they bought their home) within twenty days is similarly shocking.

Yet, that is exactly what this bill is asking you to authorize.

The prospect of a taxpayer or taxpayer's representative immediately uploading a QuickBooks general ledger file to the e-filing system in response to a letter with a request to the Examiner to narrow what they want, and then being told that they would not be allowed to produce the

back-up to their entries because they did not provide the back-up within the twenty days is completely unacceptable.

Yet, that is exactly what this bill is asking you to authorize.

There are many of situations like these tantamount to forfeitures that this bill would facilitate. And there are further problems...this bill should not move forward.

First, once tax practitioners understand the meaning of this provision, this measure will transform completely routine audits into record-keeping exercises. Each and every document will have to be recorded because of the structure of the law. Instead of resolving issues, the Department and Taxpayers will be side-tracked into keeping track of document production.

As a representative, to avoid any potential problems should a routine audit have to be appealed, I would have to advise my client to produce anything and everything that could be remotely relevant or possibly be introduced as evidence. The burden on the Department to index those materials, so that they could then attempt to preclude them in an appeal, would take considerable time and resources away from actual examinations and audits.

Tax Court litigation would then become focused on whether particular materials were actually requested, or not, produced, or not, and evidence preclusion, instead of addressing tax matters. Instead of working on substance, litigation would focus on the details of the underlying administrative procedure in a way completely unrelated to the substantive issues.

Second, many of the materials the Department typically requests are already in the Department's possession by virtue of information sharing and third party informational filings. It is non-sensical for the Department to request federal tax returns and withholding information, for instance, when that material is available to the Department via information sharing or already filed with the IRS or Department by a third party pursuant to law. This bill makes no exceptions for materials already in the possession of the Department.

Third, this provision could conflict with HRS §237-41 and similar provisions (§235-102 Records and special returns) ostensibly only requiring records to be kept for three years.

237-41 Records to be kept; examination. Every taxpayer shall keep in the English language within the State, and preserve for a period of three years, suitable records of gross proceeds of sales and gross income, and such other books, records of account, and invoices as may be required by the department of taxation, and all such books, records, and invoices shall be open for

examination at any time by the department or the Multistate Tax Commission pursuant to chapter 255, or the authorized representative thereof.

If the Department requests records more than three (3) years old, in a GE Audit, do those records have to be produced, or not? Precluded, or not?

Fourth, twenty days is too short a period for many taxpayers as regular mail may not reach them for days or, depending upon whether the Department has updated addresses, weeks. Foreign taxpayers may not receive notice for months depending whether the Department has affixed the correct postage and correctly configured the address.

Mail is also problematic as many people rely upon their electronic devices. The Department does not use the e-filing system, to my knowledge, for Exam notices, so Taxpayers do not receive an email notifying them of correspondence. While I don't believe this bill should move forward, if it does, the Department should be required by law to post all examination notices on the e-filing system, with email notification, in addition to regular mail.

Twenty days is too short to locate records, and, if records are lost or missing, to obtain new records in many contexts. Many payroll departments are unable to promptly produce W-2s, and vendors cannot always produce account histories in a short period of time.

Twenty days is incredibly burdensome for professionals who prepare taxes, who are typically unavailable to assist audit clients for extended periods in February-April and August-September. Persons seeking representation simply might not be able to obtain representation.

Ninety days is a more reasonable figure given the consequences of non-production. All exam notices by the Department should have the law printed in regular font on the notice.

The burden of proof should be on the Department to demonstrate the exam notice was received and any particular document reasonably requested in a manner calculated to put a taxpayer on notice of the identity of the document.

Fifth, Payment Under Protest is truly "last chance saloon" for correcting errors in assessments. If a taxpayer is willing to pay to access the Court, they should not be constrained by procedural rules designed for administrative convenience. Our society should almost always have a way to correct true injustices, and restricting the Payment Under Protest in any way would undermine this rarely-used remedy.

Finally, in the interest of substantive fairness, if a taxpayer timely produces documents during an audit in compliance with a demand, and subsequently

substantially prevails in a Tax Appeal or Payment Under Protest proceeding, they should recover their attorneys fees and costs against the Department as determined by the Tax Court. Suitable language can be modified from 26 U.S. 7430(a).

Many times appeals are not the result of absence records or the lack of production but the Department not agreeing with the conclusions to be drawn from the records.

/s/ Richard McClellan

SB-3176-SD-1

Submitted on: 3/11/2024 1:50:00 PM

Testimony for JHA on 3/12/2024 2:00:00 PM

Submitted By	Organization	Testifier Position	Testify
Ikaika Rawlins	Individual	Oppose	Written Testimony Only

Comments:

Aloha Chair Tarnas, Vice Chair Takayama, and Committee Members,

My name is Ikaika Rawlins, and I am testifying in **opposition** to SB 3176.

SB 3176 proposes amendments to HRS Chapter 235 (the income tax law), HRS Chapter 236E (the estate and generation-skipping tax law), and HRS Chapter 237 (the general excise tax law) to require taxpayers under audit to respond to the Department of Taxation’s (the “**Department**”) request for production of documents and evidence within thirty (30) business days. If the taxpayer fails to respond within this timeframe, the taxpayer will be prohibited from introducing such documents or evidence, or otherwise relying upon or utilizing these documents, in any tax appeal or action under HRS § 40-35 relating to said audit.

This bill should not be allowed to pass through this Committee for several reasons. First, the 30-business day deadline to provide responsive documents and evidence to the auditor contained in the bill is an arbitrary timeframe, in that it does not take into account the scope of the auditor’s request. Whether the auditor requests 5 documents or 100 documents requiring the production of 10,000 pages of information, the deadline to respond is 30 business days in both cases.

Second, the penalty for failure to comply is too severe and raises a separation of powers issue. If the taxpayer fails to comply within the 30-business day timeframe, the taxpayer will be precluded from using any documents requested in an appeal of the audit. Auditors requests for information can, in many cases, be very broad and thus a potentially huge swath of information could be prohibited from being used on appeal should this bill pass. This restriction infringes on the power of the courts, which have their own rules to determine which evidence should be included or excluded in a tax appeal.

Third, the Department already has a remedy if a taxpayer, in the auditor's opinion, fails to timely respond to the auditor's requests for information – they can simply close the audit and issue an assessment based on "best available information".

For the foregoing reasons, I oppose SB 3176 and urge the Committee to vote "no" on this measure. Thank you for the opportunity to submit testimony on this important matter.