JOSH GREEN M.D.
GOVERNOR

SYLVIA LUKE
LT. GOVERNOR

GARY S. SUGANUMA
DIRECTOR

KRISTEN M.R. SAKAMOTO
DEPUTY DIRECTOR

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

TESTIMONY OF GARY S. SUGANUMA, DIRECTOR OF TAXATION

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

BEFORE THE:
Senate Committees on Ways and Means and Judiciary

DATE: Thursday, February 22, 2024
TIME: 9:45 a.m.
LOCATION: State Capitol, Room 211

Chairs Dela Cruz and Rhoads, Vice-Chairs Moriwaki and Gabbard, and Members of the Committees:

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

S.B. 3176 amends section 235-108, Hawaii Revised Statutes (HRS), which governs audit procedures for State net income tax, section 236E-18.5, HRS, which governs audit procedures for the State's estate and generation-skipping transfer tax, and 237-39, HRS, which governs audit procedures for the State's general excise tax in two key ways: (1) By imposing a deadline for taxpayers who are 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.

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 will clarify the "time required by law" for taxpayers to supply information requested by the Department during an audit by providing a statutory deadline of 20 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 will assist the Department with obtaining information necessary for the audit in a timely manner.

Consequence for Faily to Comply With Demand for Records During Audit

As noted above, this bill will prohibit taxpayers who fail to comply with the Department's written demand for records during an audit from introducing those records during a tax appeal, unless the failure is due to reasonable cause and not neglect or refusal.

Many taxpayers ignore the Department’s requests for information or refuse to permit the Department to examine records during an audit, which thereby requires the Department to expend time and resources to obtain information from third parties and prepare an assessment based on the best available information. Then, after conclusion of the audit and after a final assessment is issued, the taxpayer opts to produce the records for the first time during a tax appeal.

Proceeding to an appeal when a dispute between the Department and the Taxpayer could have easily been resolved prior to assessment has created significant burdens for the Department, and also burdens the Judiciary, who must hear the tax appeal, and the Department of the Attorney General, which is charged with representing the Department in tax appeals. Incentivizing taxpayers to be more responsive and forthcoming during the audit stage 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.

LEGISLATIVE TAX BILL SERVICE

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: HB 2487, SB 3176

INTRODUCED BY: HB by SAIKI; SB by KOUCHI (Governor's Package)

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 twenty 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.

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.

The twenty-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 20 days is the deadline to respond to both requests. An arbitrary 20-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 information 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 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.

Digested: 2/4/2024

Richard Paul McClellan III
LAWYER
www.taxsolutionslawyer.com

February 18, 2024

COMMITTEE ON WAYS AND MEANS

Senator Donovan M. Dela Cruz, Chair
Senator Sharon Y. Moriwaki, Vice Chair

COMMITTEE ON JUDICIARY

Senator Karl Rhoads, Chair
Senator Mike Gabbard, Vice Chair

Re: **SB3176 RELATING TO TAX ENFORCEMENT**

Hearing Date: 2/22/2024, 9:45 A.M.

Dear Chairs Dela Cruz and Rhoads, Vice-Chairs Moriwaki and Gabbard, & Honorable Committee Members:

As a licensed attorney practicing for thirty years in tax controversies, I strongly oppose Senate Bill 3176 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 the Tax Court not being able to award a person 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.

1/ This Bill Would Transform Audits Into Record-Keeping Exercises.

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.

The Department will be in a position to leverage any oversights or non-production during the audit process. Again, the question in an audit is the correct amount of tax owed, not whether a taxpayer complied with any and all demands within twenty (20) days.

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.

2/ Litigation Would Be Transformed from a Truth-Seeking Process to an Evidentiary Review of the Record Below.

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.

3/ This Bill Contains No Exception for Materials Already in the Department's Possession or Control.

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, i.e. 1099s.

This bill makes no exceptions for materials already in the possession of the Department.

4/ Conflicts with Existing Laws.

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?

5/ Twenty Day Period Is Too Short.

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.

6/ Substantive Fairness Requires that the Burden of Proof Should Be Put on the Department to Demonstrate A Request Reasonably Identified the Materials Sought In a Way that an Ordinary Person Would Understand.

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

7/ This Rule Should Not Apply to Payment Under Protest Actions, the Last and Most Expensive Way of Correcting Errors in Assessments, and A Procedure Rarely Used.

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 say would greatly undermine this rarely-used remedy.

8/ In Matters Where Documents are Timely Produced, the Department Should Be Responsible for Attorney's Fees and Costs if the Department Does Not Prevail in Subsequent Litigation.

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

(808) 523-0449
Thomas Square Centre, 846 S. Hotel Street, Suite # 308
Honolulu, HI 96813