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TESTIMONY OF
GARY S. SUGANUMA, DIRECTOR OF TAXATION

TESTIMONY ON THE FOLLOWING MEASURE:

S.B. No. 3176, S.D. 1, H.D. 1, Relating to Tax Enforcement.

BEFORE THE:

House Committee on Finance

DATE: Thursday, March 28, 2024

TIME: 2:00 p.m.

LOCATION: State Capitol, Room 308

Chair Yamashita, Vice-Chair Kitagawa, and Members of the Committee:

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

S.B. 3176, S.D. 1, H.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 has a placeholder effective date of July 1, 3000 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.



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March 28, 2024

Representative Kyle T. Yamashita, Chair
Representative Lisa Kitagawa, Vice Chair
House Committee on Finance
Hawai'i State Legislature

Via E-mail

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

Dear Chair Yamashita, Vice Chair Kitagawa, 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).

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 HD 1

INTRODUCED BY: House Committee on Judiciary & Hawaiian Affairs

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: July 1, 3000; 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 the House Committee on Judiciary on February 6, is the arbitrary response period, which Senate Ways and Means lengthened from 20 days to 30 business days.

Digested: 3/26/2024



March 27, 2024

The Honorable Kyle Yamashita
Chair, House Finance Committee
Hawai'i House of Representatives
Hawai'i State Capitol, Room 306
415 South Beretania St.
Honolulu, HI 96813

Dear Chair Yamashita, Vice Chair Kitagawa, and members of the House Finance Committee:

CTIA writes to respectfully request the Committee's consideration of proposed amendments to Senate Bill 3176 included in our testimony.

CTIA's membership is made up of telecommunications companies who conduct business in nearly every state in the country, including Hawaii. Like other taxpayers, our members regularly participate in audits as required in states where they are subject to taxes. We understand the Department of Taxation's goals with this bill, and we offer amendments intended to remain consistent with the Department's goals while addressing our members' concerns.

Timelines

We understand that the Department of Taxation is seeking to impose a timeline by which taxpayers must respond to their requests. We also appreciate a prior amendment to extend the timeline from "twenty days" to "thirty business days." We respectfully request that the timeline be extended further to sixty business days and for language to be included to explicitly authorize the Director to provide for extensions. We propose the following amendments:

Any person liable for any tax imposed under this chapter 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~~ sixty business days after a written demand is mailed to that person by the department received by a designated person, or as soon thereafter as the director may deem reasonable under the circumstances. The director may upon a timely request setting forth good and sufficient cause or at the director's discretion extend the 60-day period. A request may not be denied unreasonably by the director.

Many of our members are large companies operating in all 50 states, including states with local jurisdictions who have the authority to conduct audits of various local taxes and fees. For this reason, a request from the Department of Taxation could take more than thirty days to be routed to the right person or people who would be responsible for engaging with the Department on their request. Collecting and organizing the information in a manner acceptable to the Department may take



additional time if the request involves a large number of transactions. Information may also require legal review prior to remittance to ensure sensitive information is not inadvertently disclosed. If this is the case, information may need to be reviewed by companies' departments outside of their general audit group. Finally, it may take longer to obtain information if it is held by third party companies that facilitate transactions on the taxpayer's behalf.

We appreciate the Director's comments in prior testimony that he would be willing to provide extensions and our goal with the proposed language is to incorporate that intent in the bill.

Evidentiary Restriction

Our members are especially concerned with the language in the bill that prohibits documents or other evidence from being used during an appeals process if such materials were not provided to the Department during the audit process.

We understand from the Director's prior testimony that the intent of the bill is to encourage taxpayers to participate in the audit process and that the primary purpose of the proposed restriction is to be used against those who ignore or refuse to cooperate with the Department. However, the current language could be read as requiring documents or evidence not provided in the audit process to be *automatically* prohibited unless a taxpayer can provide a reason why such document was not provided earlier. This is broad and could unnecessarily burden taxpayers who have cooperated with the Department in good faith. As such, we propose the following amendments:

Any person who fails to produce documents or evidence as provided in this subsection ~~shall~~ **may** 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~~ **if it is shown that the failure is due to willful neglect.**

Our intent by proposing to change the word "shall" to "may" is simply for the restriction to not occur automatically while leaving the ability for the restriction to be applied as the Department envisions.

We also propose to change the standard that must be met to a standard that may be easier for a court to apply. The current language provides two standards for a court to decide: reasonable cause and neglect/refusal. It could be assumed that proving one shows evidence of the other but having both standards in statute could make it unnecessarily difficult for the taxpayer to overcome even when working in good faith, which is why we propose the "willful neglect" standard. We also propose removing the term "refusal" because there are circumstances where a taxpayer may be unable to provide the Department with requested information without first obtaining a protective order.

Again, our intent with the proposed amendments included in our testimony today is to address our members' concerns without compromising the Department's goals to hold taxpayers accountable as



appropriate. We appreciate the opportunity to submit testimony and the Committee's consideration of our proposed amendments.

Sincerely,

Annissa Reed

Annissa Reed
Director
State and Local Affairs