

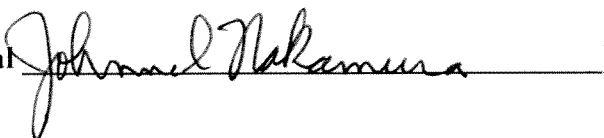
Department of Taxation

TAX AUDIT GUIDELINE 2009-01

TO: COMPLIANCE DIVISION

FROM: RULES OFFICE

[Rules Officer Approval

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RE: HAWAII CIVIL TAX PENALTY MATRIX

DATE: OCTOBER 26, 2009

The purpose of this document is to provide Compliance Division personnel with an analytical matrix of the various civil penalties assessable under Title 14, Hawaii Revised Statutes. These penalties are specifically discussed because they require the Auditor's discretion and judgment in assessment. This document serves as a high level "issue spotting" tool that may be utilized when considering whether a penalty is appropriate for a particular case.

This analytical guideline is for internal use only, is intended to be a reference tool, and is not authoritative. Relevant Hawaii and federal statutes, administrative rules and regulations, case law, and formal Department of Taxation positions (TIRs) will control over this document.

Civil Penalty Checklist In Order of Relevant Consideration

- Failure to File Tax Return
- Substantial Understatement or Misstatement of Tax
- Erroneous Refund Claim
- Negligence
- Fraud
- Understatement of Tax Liability by Tax Return Preparer (assessed against preparer)
- Promoting Abusive Tax Shelter (assessed against promoter)

Failure to File Tax Return—HRS § 231-39(b)(1)

- Imposes a penalty equal to 5% of the amount of tax required to be shown on the return per month, not to exceed 25% of the amount of tax, for failing to file a tax return required by law.
- Extensions to file are taken into account in determining whether a return is filed timely. Therefore, where an extension is filed, the deadline for purposes of the penalty is extended.
- Penalty does not apply to failure to file declarations of estimated tax under HRS § 235-97.
- Penalty may be remitted if failure to file is due to "reasonable cause and not due to neglect."
- An erroneous belief that no tax liability was due or owing is not "reasonable cause." *In re Grayco Land & Escrow*, 57 Haw. 436.
- "'Reasonable cause' has been interpreted to mean no more than the exercise of ordinary business care and prudence. However, a mere showing of absence of willful neglect is insufficient to avoid the penalty.****It is generally recognized that the presence of certain factors, in addition to the honest belief of the taxpayer, constitutes reasonable cause for the failure to file a return, e.g., the advice of a competent accountant or attorney." *In re Grayco Land & Escrow*, 57 Haw. 436.

Substantial Understatement or Misstatement of Tax—HRS § 231-36.6

- Imposes a penalty equal to 20% of the portion of an underpayment attributable to an understatement of tax.
- There is an understatement of tax for a taxable year where the understatement exceeds the greater of 10% of the tax required to be shown on the return; or \$1,500 (\$30,000 for C Corps).
- Understatement amount is reduced by portions attributable to positions with substantial authority or where adequately disclosed and there is a reasonable basis.
- "Understatement" means the excess of the amount of tax required to be shown on the return over the amount of tax shown on the return.
- This penalty is in addition to any other penalty assessable.
- The Director must approve assessment of this penalty.

Erroneous Refund Claims—HRS § 231-36.8

- Imposes a penalty equal to 20% of the excessive amount associated with erroneous claims for refund or credit.
- "Excessive amount" means the amount by which the amount of refund or credit claimed exceeds the amount of credit or refund allowable.
- No penalty is assessable where the penalty is less than \$400. Therefore, there can be no penalty where the excessive amount is less than \$2,000. Temp. HAR § 18-231-36.8-01-6676T(e).
- No penalty is assessable where there is a reasonable basis for the claim.
- "Reasonable basis" means a standard of care that is not frivolous or patently improper. The position must be more than arguable and have at least one or more supporting authorities. Such a position is one where a person knowledgeable in tax law would lead the person that the position has a 1-in-4 chance (25%) of success on the merits.

Reasonable basis includes innocent mistakes and inadvertent math errors. There is no reasonable basis where a person knows the position or claim will not qualify.

- The burden of proof is on the taxpayer.
- The Director must approve assessment of this penalty.

Failure to Pay Tax Due to Negligence—HRS § 231-39(b)(2)(A)

- Imposes a penalty of up to 25% of an underpayment due to negligence or intentional disregard of rules (but without intent to defraud).
- "The term 'negligence' includes any failure to make a reasonable attempt to comply with the provisions of the [tax] laws or to exercise ordinary and reasonable care in the preparation of a tax return. 'Negligence' also includes any failure by the taxpayer to keep adequate books and records or to substantiate items properly." Treas. Reg. § 1.6662-3(b)(1).
- "The term 'disregard' includes any careless, reckless or intentional disregard of rules or regulations****A disregard of rules or regulations is 'careless' if the taxpayer does not exercise reasonable diligence to determine the correctness of a return position that is contrary to the rule or regulation. A disregard is 'reckless' if the taxpayer makes little or no effort to determine whether a rule or regulation exists, under circumstances which demonstrate a substantial deviation from the standard of conduct that a reasonable person would observe. A disregard is 'intentional' if the taxpayer knows of the rule or regulation that is disregarded." Treas. Reg. § 1.6662-3(b)(2).
- There is no reasonable cause exception to this penalty.
- Burden of proof is on the taxpayer.

Failure to Pay Tax Due to Fraud—HRS § 231-39(b)(2)(B)

- Imposes a penalty of up to 50% of an underpayment required to be shown on a return due to fraud. If a fraud penalty is assessed, there can be no civil penalty for failure to file.
- Whether fraud exists depends upon the facts of each case. Unless admitted by the taxpayer, fraud is typically proven circumstantially by demonstrated "badges of fraud."
- A fraud penalty would be appropriate where an underpayment is due to falsity, evasion, concealment, or other similar facts.
- Burden of proof is on the government to show fraud.
- There is no reasonable cause exception to this penalty.
- Filing amended returns to correct fraudulent original returns does not preclude assessing the fraud penalty on original returns. *Frank v. Comm.*, 13 TC 253 (1949).

Understatement of Tax Liability by Tax Return Preparer—HRS § 231-36.5

- Generally, imposes a \$500 penalty on a tax return preparer who understates a person's tax liability by taking an unreasonable position.
- Imposes a \$1,000 penalty on a tax return preparer who willfully understates a person's tax liability or recklessly disregards any tax law or rule in understating a person's tax liability based upon an unreasonable position.
- Penalties apply per return prepared.
- An understatement due to an unreasonable position occurs when:
 - Any part of a return or claim is based on a position that does not have substantial authority;

- The tax return preparer knew or should have known of the unreasonable position; and
- The position was not disclosed or was frivolous.
- A position is disclosed where there is an attachment of an analysis of the position and there was a reasonable basis for the position.
- "Substantial authority" means statutes, rules, rulings, announcements, TIRs, committee reports, etc.
- "Tax return preparer" is broad and includes persons beyond those signing the return.
- "The tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete." Temp. HAR § 18-231-36.5-01-6694T(a)(1).
- The Director must approve assessment of this penalty.
- Tax preparers have appeal rights pursuant to HRS § 231-36.5 independent of the audit of the tax return at issue. See Rules Office for procedural guidance on issuing this penalty and preparer's appeal rights.
- A tax preparer may be enjoined for certain prohibited acts. Injunctions are handled by the AG after referral from the Department.

Promoting Abusive Tax Shelters—HRS § 231-36.7

- Imposes a penalty of \$1,000 or the amount of gross income received, whichever is less, for the promotion of an abusive tax shelter. Each act of promoting a tax shelter constitutes a separate violation.
- A person "promotes an abusive tax shelter" by:
 - Organizing or assisting in the organization, or participating in the sale of an interest in an entity or other plan or arrangement; and
 - In connection with such activity, a statement is made or a person is caused to make a statement respecting whether a deduction or credit is allowed, income may be excluded, or other tax benefit may be secured; that the person promoting knows or has reason to know is false or fraudulent or is a gross valuation overstatement.
- Penalty may be remitted with respect to a gross valuation overstatement if there was a reasonable basis and the valuation was made in good faith.
- "Gross valuation misstatement" means a statement of value for property or services where the value stated exceeds 200% of the correct value and the value is directly related to an amount of credit or deduction allowable.
- A safe harbor from this penalty is available where a tax shelter promoter obtains a favorable ruling from the Department. Temp. HAR § 18-231-36.7-01-6700T(d).
- This penalty is in addition to any other penalty assessable.
- The Director must approve assessment of this penalty.
- See Rules Office for procedural guidance on issuing this penalty and preparer's appeal rights.
- A promoter may be enjoined for certain prohibited acts. Injunctions are handled by the AG after referral from the Department.