TAX FOUNDATION
OF HAWAII

126 Queen Street, Suite 304, Honolulu, Hawaii 96813, Telephone 536-4587, *www.tfhawaii.org*

OFFICERS

Manoj Samaranayake
Chair

Ronald I. Heller
Vice Chair

Thomas Yamachika
President/Secretary

Kenneth L. Rhodes
Vice President/Treasurer

BOARD
OF DIRECTORS

Dennis Brown
Helen Chang
Jay Chen
Brent Flygar
Ronald I. Heller
Michael Kam
Ross Kohara
Cyrus Oda
Lon K. Okada
Michael J. O'Malley
Ku'uhaku Park
Randall Roth
Manoj Samaranayake
Glenn Shigetomi
Lauralei Tanaka
Kieran Yap

EXECUTIVE ADVISORY
BOARD OF DIRECTORS

Meredith J. Ching
Roger H. Epstein
Richard Henderson
Richard R. Kelley

October 16, 2018

Rules Office
Hawaii Department of Taxation
830 Punchbowl Street, Room 221
Honolulu, HI 96813

Re: **Proposed HAR § 18-237-34-13, Relating to Persons with a Material Interest in a GET Return (the "Material Interest Rule")**
Public Hearing: Oct. 19, 2018

Ladies and Gentlemen:

We have significant concerns about this proposed rule, which appears to us to be contrary to the law on which the rule is based and having the potential to destroy the confidentiality of tax return information that taxpayers and tax preparers expect. **We urge that the rule be withdrawn immediately.**

Under the General Excise Tax Law, there are several income splitting, deduction, and reduced rate provisions designed to mitigate or eliminate the "pyramiding" effect of gross receipts taxes. For example, if a general contractor G hires a subcontractor S to work on a certain job, G is taxable on the gross income received from its client but is permitted under certain circumstances to deduct the amount G pays to S under HRS §237-13(3), in which case both G and S are taxable at the retail GET rate of 4%. There may be a dispute about whether S is a subcontractor for purposes of this deduction provision; S, for example, may think it is a "service provider" entitled to the wholesale GET rate of 0.5% on the theory that its services on the project are being resold by G. The Material Interest Rule, by defining G as having a material interest in S's return and vice versa, would allow the Department to show G all or any part of S's return, and to show S all or any part of G's return.

Apparently, the Material Interest Rule is designed to promote consistency in the tax return positions being taken by G and S. The rule contains a proviso "that the department will only disclose return information of a taxpayer if the person with a material interest is under audit or examination by the department and the department determines that the return information is directly relevant to the tax liability of the person under audit or examination." The rule also directs the department to "maintain the confidentiality of information that is not directly relevant by taking appropriate action, including redacting confidential information."

The Material Interest Rule Conflicts with Its Governing Statute.
Section 237-34, HRS, specifically defines persons with a material interest in the return, return information, or report. It states: "Unless otherwise provided by law, persons with a material interest in the return, return information, or report shall include:" and then enumerates thirteen separate categories of persons. Although use of the word "includes" in a statutory definition normally means that the definition could encompass things that are not enumerated in the statute, this statutory definition starts with "Unless otherwise provided by law," which implies that the enumeration in the statute is not to be expanded except by another statute. That language implies that the Department is not given the authority to expand the disclosure exemptions administratively.

This conclusion is reinforced by the history of the provision. Prior to 1981, section 237-34, HRS, provided that the Department of Taxation may permit the inspection of any return by any person "upon being satisfied that the inspection is desired for some lawful and proper purpose." HRS §237-34 (1976); Act 139, SLH 1974, sec. 5.

In 1981, the Department of Taxation introduced an administration bill Q-17 (1981) for the purpose of amending section 237-34, HRS, to afford taxpayers the same confidentiality to general excise tax returns as was required under the income tax laws. The Department's bill, enacted as Act 170, SLH 1981, gave section 237-34 its current structure by providing that it shall be unlawful to disclose information contained on general excise tax returns to any person other than the taxpayer, an authorized agent, or persons with a material interest in such return that were further defined in the statute. The prior language giving the Department authority to permit inspection of the returns did not appear in the statute as amended. The inescapable conclusion is that the Department willingly gave up that authority.

Simply put, the 1981 amendment prescribed very specific categories of persons with a material interest in a return and made clear that the Department no longer has administrative authority to prescribe disclosure exceptions. This proposed rule, by expanding the statutorily defined classes of persons with a material interest in a return, can only be valid if the Department has legislative authority to do this. We therefore conclude that this proposed rule goes beyond the authorizing statute and is invalid. *Agsalud v. Blalack,* 67 Haw. 588, 591, 699 P.2d 17, 19 (1985) ("it is axiomatic that an administrative rule cannot contradict or conflict with the statute it attempts to implement"); *Jacober v. Sunn,* 6 Haw.App. 160, 167, 715 P.2d 813, 819 (1986) (holding that an administrative agency "may not enact rules and regulations which enlarge, alter, or restrict the provisions of the act being administered").

The proviso that the Department will only disclose information in case of an audit, and the other purported protections against disclosure of other confidential return information, are wholly unsupported by the statutory text. The problem is that information from a subcontractor's or income splitter's return should not be disclosed to the taxpayer under audit in the first place, under pain of criminal penalties.

The Material Interest Rule Allows the Department to Excuse Itself from a Felony
Section 237-34, HRS, is a *penal* statute, prohibiting conduct by officers or employees of the State upon pain of being punished for a class C felony. It would be odd indeed if the very persons whose conduct is subject to these restrictions can excuse themselves by administrative fiat. But that is

precisely what these rules do! Under its purported rulemaking authority, the Department is excusing itself from the strictures of the confidentiality statute in the broad class of cases covered by the Material Interest Rule.

The Material Interest Rule Is Not Needed to Determine Proper Tax Treatment

Department of Taxation Announcement 2016-04, which appears to bear on the issue addressed here, states that "to properly review and assess the appropriate tax, the Department must examine more than one taxpayer's return. For example, when a general contractor takes a subcontractor deduction pursuant to section 237-13(3), HRS, the Department will examine the general contractor's and subcontractor's returns. If an assessment is made against the general contractor, the Department may need to disclose relevant portions of the subcontractor's return to the general contractor." Certainly, the Department may want to examine the general's and the sub's return in this situation to see if the taxpayers are taking inconsistent positions. However, whether the deduction is properly taken depends on the facts and the law, not on the position taken by the other taxpayer on its return. The Department has been auditing wholesalers, retailers, contractors, and those claiming GET benefits since the tax was originally enacted in the 1930's; has lived with GET return confidentiality since 1981; and has not clearly shown that its ability to adjust such taxpayers' returns has been substantially impaired over the last 35 years. The Material Interest Rule is not necessary and has the potential to cause significant harm.

For these reasons, the Foundation urges the Department to withdraw the Material Interest Rule immediately.

Thank you for considering these comments.

Very truly yours,

Thomas Yamachika
President

c: Director of Taxation
Hawaii State Bar Association, Tax Section
Hawaii Society of CPAs, Tax Section
Hawaii Society of Enrolled Agents
Building Industry Association
General Contractors' Association
Hawai'i Lodging and Tourism Association
Waikiki Improvement Association