TAX REVIEW COMMISSION

MINUTES OF THE THIRTEENTH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT 830 PUNCHBOWL STREET, ROOM 221
IN THE CITY AND COUNTY OF HONOLULU
STATE OF HAWAII, ON TUESDAY, MAY 30, 2006

The Commissioners of the Tax Review Commission met at the Department of Taxation, Director Conference Room, in the City and County of Honolulu, State of Hawaii, on Tuesday, May 30, 2006.

Members Present: Chairman Isaac Choy, Manoa Consulting Group, LLC CPA's
Vice-Chairman Ronald Heller, Torkildson Katz Fonseca Moore & Hetherington, AAL, ALC
Christopher Grandy, UH Manoa, Public Administration Program
John Roberts, Niwao & Roberts, CPA's
Carolyn Ching, Carolyn L. Ching CPA
Lon Okada, Hawaiian Electric Industries, Inc. (arrived late)

Members Absent: Melanie King, Bank of Hawaii

Staff: Tu Duc Pham, Donald Rousslang, Cathleen Tokishi

Other: Peter Fritz, Chun Kerr Dodd Beaman & Wong
Lowell Kalapa, Tax Foundation of Hawaii
Marilyn Niwao, Niwao & Roberts, CPA's
Diane Erickson, Dept. of Attorney General
Tom Smyth, DBEDT
Johnnel Nakamura, DOTAX
Dana Remigio, DOTAX

CALL TO ORDER

Chairman Isaac Choy called the meeting to order at 9:05 a.m. with a quorum present.

APPROVE MINUTES OF APRIL 25, 2006, MEETING

Chairman Choy asked that the draft minutes be amended on page 7 to indicate that he had three questions rather than four.

It was moved by Mr. Heller and seconded by Ms. Ching to approve the minutes of April 25, 2006, as amended. The motion carried without opposition.

ANNOUNCEMENTS

The Chairman introduced Dana Remigio, the Commission's new secretary. Commissioners should, however, send their e-mail to Dr. Rousslang for distribution as necessary. He also reminded the commissioners that the decision had been made to hold longer meetings to get through the list of items that need to be considered, but that the commission did not have to continue its meetings through the end if its work concluded earlier.

The Chairman also announced that he had distributed an outline of the report for consideration, and Ms. Malama had previously distributed the suggestions. He also confirmed that the members had received the 25-page internal study on general excise tax exemptions. Dr. Pham stated that the study was an interim report and that additional changes may be made if time permits.

The Chairman also stated that he had begun assembling a binder of things that could be included in the report. He encouraged the members to submit anything that they'd like included.

REPORT ON STATUS OF CONTRACTS FOR EXTERNAL STUDIES

Dr. Rousslang stated that both contracts had been finalized. Interim reports are due about 60 days before the final report; sometime in September. Dr. Rousslang will e-mail everyone if that information is not correct.

REPORT ON STATUS OF WORK ON INTERNAL STUDIES

Review of the progressive and regressive nature of overall taxes.

Dr. Rousslang stated that this study is being done differently than previous studies. It will be based on adjusted gross income (AGI), rather than the typical expanded, constructed, imputed, total income so someone can look at the study and tell what income class they're in.

Dr. Pham said that AGI is not total income; it may not include, for example, retirement income. It is up to the Commission whether they want to include the profile or not. Dr. Grandy asked why AGI instead of total income.

Dr. Rousslang stated that there was a critique written by the Joint Economic Committee based on what the Treasury Department had been doing for distributing tax burdens. It pointed out that someone could look at it and be unable to determine what income class they were in by the time they got through imputing the value of an owner-occupied home, etc.; it was very inexact. Is

pension income included when you earn it or when you retire and get to spend it? So, we're taking a simpler view from profiles of typical taxpayers and looking at the burden they bear.

Dr. Grandy stated that it sounded like the short answer would be because we're trying to construct this in a way that would be more accessible to the lay reader. Dr. Rousslang added that it would be more transparent as to its problems and faults as well.

Mr. Smyth mentioned that it had previously been recommended that federal AGI be used. Dr. Rousslang stated that it would indeed be federal AGI, not Hawaii AGI, that would be used. The Commission agreed that the federal AGI should be used.

Study on "tax adequacy" (how tax collections change automatically as income grows).

Dr. Rousslang stated that the draft was completed but had not yet been sent out. Dr. Pham stated that, if the law doesn't change, then tax collections will be slightly more than the change in income; around 1.04 or 1.10. Dr. Rousslang said that there are two ways of looking at this. If you leave the tax structure untouched, then it is, preliminarily, 1.04; that is taxes will grow about 4% more than income. But there is another way of looking at this; if the Legislature intervenes and adjusts the tax structure, as it did this year, then it looks to be about exactly 1.0 from 1972 (just looking at general funds).

Dr. Pham stated that his office had to adjust their database due to changing law such as the ERTF (Economic Revitalization Task Force), weekend effects on general excise tax collections, depyramiding, etc. Also changes in tobacco and transient accommodations tax rates, although the tobacco tax was tricky as increased enforcement by the State Attorney General's Office caused collections to shoot up dramatically.

Dr. Rousslang stated that these adjustments were needed to get what is called the constant law tax collections; what the structure would generate automatically if there were no changes in the law, no changes in the proportions dedicated towards the general fund, etc.

The Chairman asked if there were any other factors considered such as an increase in the economy. Dr. Rousslang stated that this is one of the flaws of this exercise. The study merely shows how tax revenues have grown historically as income has grown. But income can grow for various reasons; population can grow, you can have inflation, the structure could change (more military growth and less tourist growth or vice versa). How the economy grows impacts how collections grow. In the future, if growth comes from population growth rather than income growth, or if it comes from the military instead of tourism, the tax adequacy number provided might not fit.

Dr. Pham explained that, with tourism, for example, the 4% general excise tax revenues show up immediately. Military expenditures, however, may be largely exempt; even military expenditures to nonresident military personnel would not be subject to income tax.

Dr. Grandy stated that he didn't think people would expect the study to provide a precise forecast. It's more a structural thing; if we make these assumptions, what will elasticity look like. If the elasticity was 0.8 or 1.5, then tax adequacy would need to be addressed. Within gross parameters, this number is useful as a check.

Effects of an earned income credit; effects of increasing the standard deduction; effects of expanding the income tax brackets. Dr. Rousslang stated that the Tax Research and Planning Office did these calculations for bills heard during the 2006 Legislative Session. Dr. Pham stated that the Legislature passed an increase in the standard deduction to 40% of the federal amounts and expanded tax brackets by 20%. The earned income tax credit (EITC) would help 1 out of 8 taxpayers (72,000 returns). For so-called "poor" taxpayers with income under $30,000, only 1 out of 5 would be helped by the EITC. The increased standard deduction would help about 300,000 taxpayers. The expansion of the income tax brackets helps almost everybody.

Dr. Grandy asked, and it was confirmed, that the law that passed was written in terms of dollars rather than as a percentage of the federal amount, and that the standard deduction increase to 40% of the federal amount would erode over time. Dr. Pham stated that the Department of Budget and Finance wanted to schedule a 3-year review. Because this is very hard on the budget, they want a more precise number on its revenue impact.

The Chairman asked if the Commission should look at indexing the amounts instead of a dollar amount so it doesn't fall behind. There was general consensus that this was a good idea. Dr. Pham stated that his office would try to do some estimates based on indexing and report back to the Commission.

The Chairman asked if the time schedule that was decided on during the initial meetings was being met. Dr. Rousslang stated that it is being held to as best as the Tax Research and Planning Office can. Dr. Pham concurred that the schedule can still be followed.

Dr. Pham stated that they are still waiting on the Commission's review of past recommendations, and asked that anything they had be sent to Dr. Rousslang. The Chairman confirmed that problems noted by Ms. Ching were corrected and the list distributed by Dr. Rousslang.

DISCUSS PROCEDURE FOR EVALUATING PROPOSALS LIKELY TO COME UP AT THE NEXT LEGISLATURE

The Chairman noted that Dr. Rousslang had e-mailed a list of bills that didn't pass this session but that may come up next session. He identified the streamlined sales tax provision as one that is certain to be reintroduced.

Dr. Pham said that Dr. Fox had recently conducted a study that revised downward the revenue impact figure he provided to the previous Tax Review Commission to $10 million (previous estimate was in excess of $100 million). The Chairman stated that increasing Internet sales would mean that this problem will grow in the future, and that those who oppose the streamlined

sales tax will have to come up with an alternative; perhaps the Commission can propose a better alternative. Other measures such as the ethanol credit may be reintroduced but will probably not be as popular as the streamlined sales tax.

Dr. Pham mentioned that the Administration had wanted Hawaii's standard deduction to be increased to 75% of the federal amounts, but that only a 40% increase had passed. He doesn't know if the Administration will ask for the full 75% next session, but it may. Estimates for the 75% amounts were previously provided to the Commission. Bills to increase the standard deduction had been submitted in each of the last 4 years (twice under the Cayetano Administration and twice under the Lingle Administration) so it may be introduced again if the economy is good.

The Chairman asked if the Council on Revenues expects the strong economy to continue through next year. Dr. Pham stated that the Council on Revenues would be meeting that afternoon but news reports indicate that the economy may be cooling. March and April were clearly impacted by the rain, sewage spill in Waikiki, etc. Through April, the cumulative growth rate of general fund tax collections in FY 2006 over FY 2005 decreased from 12.6% in March to 9.3%, but it is expected to go up for May. March tourist arrivals, also weather-driven, were down. As of the meeting date, the May general excise tax collections were flat, but estimated tax collections increased quite dramatically.

Ms. Niwao said that the practitioners generally have their clients pay estimated taxes based on 100% of last year's tax liability to avoid the underpayment penalty. If last year was a good revenue year, the estimated tax payments may be high since it reflects the previous year rather than the current year. The Chairman noted that estimated tax payments are often adjusted in the fourth quarter, but that the current quarter is the first quarter and thus reflects the previous year.

CONTINUE EVALUATING SUGGESTIONS FROM THE PUBLIC

Dr. Rousslang summarized the results of the previous meeting; this meeting's discussion covers the previously deferred suggestions and items 29 through 36.

<u>40. Require facilitator in a 1031 exchange to remit 5% of any shortfall of the amount exchanged</u>.

The Chairman asked what a "shortfall" is. The consensus was that the shortfall is the amount of any "boot" received in addition to the replacement property received. Not just for Hawaii nonresidents, but for all taxpayers.

Mr. Heller suggested that the Commission look at suggestions 40 and 42 (revise Hawaii's adoption of IRC 1031 to require that the qualified replacement property be situated in the State of Hawaii) together.

Dr. Grandy asked for further clarification of the issues. Dr. Rousslang read the original suggestion 40 from Jon Anderson, who felt that the lack of a provision requiring facilitators of

1031 exchanges to remit 5% of the shortfall to the State when a nonresident either cancels the exchange or does not exchange fully was a flaw in the Hawaii law, noting that California has for years required facilitators to forward 3.3% of the shortfall. The Chairman pointed out that this was a withholding requirement similar to HARPTA (the requirement that purchasers of Hawaii real property withhold 5% of the sales price from the amount paid to a nonresident seller and remit that amount to the state).

Ms. Niwao clarified that, in a 1031 exchange, there is a third-party that holds the money until the exchange is completed, and that the suggestion addresses situations in which the exchange is not successfully completed. Ms. Nakamura asked if this might be covered by HARPTA, but it is not. The title company is usually the HARPTA withholding agent, but the third-party intermediary for the 1031 exchange may not be a Hawaii company and may not realize that there is a HARPTA requirement, or may feel that they are exempt.

Mr. Heller stated that if a nonresident just sells a property, then HARPTA would apply; but in a 1031 exchange, the hole in the law is that HARPTA doesn't apply to the rest of the money from the exchange. He suggested that HARPTA apply both to a sale and to any cash received in a 1031 exchange at the same rate.

It was clarified that the Form N-289 from the seller exempting the transaction from HARPTA can be given to the buyer before the 1031 exchange is completed. If the 1031 exchange doesn't go through, the HARPTA withholding falls through; the third-party facilitator is not obligated to withhold the tax due under HARPTA. Once the Form N-289 is given, future verification is not needed. If this exception is eliminated and withholding is made under the HARPTA provisions, then the seller could go back and get a refund of the amount withheld if the 1031 exchange is successfully completed.

Mr. Roberts asked if this would catch all failed 1031 exchanges. Ms. Niwao stated that she was not sure, but pointed out that she felt that a number of the facilitators were on the mainland and may not be familiar with Hawaii's withholding laws and requirements. Mr. Smyth stated that doing so would create a whole new class of payer – the out-of-state facilitators who are not even in the state – so the Commission would need to speak to them.

The Chairman asked if anyone had any revenue figures or other comments to contribute.
Mr. Roberts asked if they were saying that this was not practical and that they should not place the burden on the Hawaii trust company. There is an educational component, but they’re now going beyond that. If the facilitator is out-of-state, Hawaii cannot enforce this. Can’t force the use of a Hawaii facilitator because the replacement property could be anywhere in the nation. Perhaps title companies could provide facilitators with a brochure informing them of the procedures.

Dr. Rousslang asked if third-party facilitators always take title to the property. Ms. Niwao stated that they usually take the cash funds and act like a trustee for the funds, and when they identify the new property, they use those funds so that the taxpayer doesn't touch the cash. But
Dr. Rousslang stated that he has frequently seen conveyance tax documents where the title is

going through a third-party facilitator. Ms. Niwao stated that third-party facilitators take title to the property in reverse exchanges.

Mr. Heller stated that there were really two questions. First, should the HARPTA requirements apply to an exchange if there is cash flowing back to the seller because it is not a total-value exchange? The answer is yes in this case. Second, and this is the hard one, who has to make the report and remit the money? If it is the third-party facilitator, he doesn't think that can be enforced relative to out-of-state facilitators, and there is no point in making it a legal requirement. The Chairman pointed out, however, that there is nothing to enforce if there is no law.

Dr. Grandy asked if anyone knew how the California law was working, and suggested that the Department look at this. Johnnel will see how this has been handled. Ms. Ching pointed out that such a provision would catch most of the local facilitators, but that it would be an exception rather than the rule with respect to out-of-state facilitators.

It was moved by Mr. Heller and seconded by Mr. Roberts that the Commission adopt this suggestion as amended to require the exchange facilitator and/or intermediary to remit as a withholding at the HARPTA withholding rate any shortfall of the amount exchanged. The motion was passed with the following votes: 5-Yes.

The Chairman called for the vote:

Ronald Heller	Yes
John Roberts	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Isaac Choy	Yes
Lon Okada	Absent

42. Revise Hawaii's adoption of IRC 1031 to require that the qualified replacement property be situated in the State of Hawaii.

Mr. Roberts expressed concern regarding the interstate commerce issue, and whether the Commission would be exceeding what it could do from the federal standpoint. The Chairman noted that Ms. Nakamura would let them know if there were any legal issues; Ms. Nakamura affirmed that.

Dr. Rousslang read the original suggestion 42 from Howard Kam, who had characterized the lack of such a provision as a "gaping loophole for out-of-state investors."

Ms. Niwao stated that these investors are exchanging highly appreciated property in Hawaii for replacement property located in states such as Texas, Nevada, and Washington that do not have a state income tax. When they subsequently sell the replacement property, no tax is paid on the appreciated value to either Hawaii or the state in which the replacement property is located.

Dr. Rousslang stated that, theoretically, the reverse would happen with out-of-state property exchanged for property located in Hawaii, and that as long as all the states did the same, there would be no net movement in the investment between the states, but that is apparently not the case.

Ms. Niwao stated that the federal government recognized this as an issue with respect to foreign property, and thus requires the replacement property to be located in the U.S.

Mr. Heller noted that this had been discussed before. The military was one of the groups opposing this change because they thought it would increase the cost of rental housing for military personnel.

Ms. Niwao noted that a lot of military housing is being built. Mr. Smyth, however said that the number of military housing units are actually decreasing due to privatization, older housing being demolished and not replaced, and other housing being taken off-line for reconstruction, renovation, etc. Mr. Kalapa and others disagreed with Mr. Smyth, though Mr. Smyth maintained his position given what he does.

The Chairman asked how this change would affect rents. Mr. Heller explained that it may affect the willingness of people to invest in rental housing because they can't exchange out of it, which would in turn lead to higher housing prices. Mr. Smyth stated that the issue from DBEDT's perspective is that of the business climate, and not erecting more barriers to investment around Hawaii.

The Chairman noted, however, that the issue for the Commission is whether Hawaii is getting the tax on the appreciated value of the Hawaii property or not. Ms. Ching noted that Hawaii resident taxpayers are not the problem, because even if the Hawaii property is exchanged for property located in a state without an income tax, the Hawaii resident is taxable on worldwide income and thus the tax on the appreciation of the Hawaii property will be paid to Hawaii. The compliance problem is with nonresidents.

The Commission decided to defer voting on this suggestion until further information on what other states are doing is obtained. Mr. Kalapa asked that the situation of large landowners of tracts obtained prior to the 20th century who would like to make land available to investors for development be considered, particularly when the landowners do not have the resources to develop the land themselves. One example is the Campbell Estate.

20. Take measures to force compliance by out-of-state lessors.

Dr. Rousslang read the original suggestion 20, which was submitted anonymously. Concern is with out-of-state lessors not filing returns and paying for the Hawaii income tax and general excise tax.

The submitter's first suggestion was to require management companies to obtain the general excise tax license number of lessors and to put the license number on the lease so that tenants could report the number on their income tax returns, which the Department could then follow-up on to enforce compliance. However, management companies are already required to notify the Department of the leasing activity by filing Form 1099 with the Department and to notify the lessor of the State's taxation requirements by including specific information on rental collection agreements. Therefore, it is really a matter of enforcement by the Department.

Mr. Heller stated that the problem is more with out-of-state management companies rather than with local companies, but Ms. Niwao stated that this is a problem with at least some local companies with out-of-state lessor clients as well. Mr. Kalapa pointed out that there is no need for additional law since the law exists.

The Chairman asked if this was something that only needs to be brought to the attention of the Department. Dr. Rousslang, however, noted that the suggestion was to have the general excise tax license number noted on the lease. Ms. Nakamura stated that this requirement had been included in legislation this year that was not passed.

If a lessor files an income tax return, then the Department should be able to follow up on information provided on the return. If no return is filed, the Department should be able to follow up on information provided on Forms 1099 that management companies file with the IRS and the Department.

Ms. Niwao stated that there nonetheless is a big problem with the nonfiling of income tax and general excise tax returns by lessors, based on new clients who need to have their filing caught up on.

The Chairman noted that general excise tax license numbers have been required on the resident Form N-11 for years, and asked if the Department can cross-check that information with general excise tax records. Ms. Ching stated that she has gotten audit notices from the Department based on that return information; this is a new development.

The problem remains, however, with persons who don't file any tax returns at all and who therefore remain outside the system. Mr. Roberts stated that this is common on Maui. The only way to catch this is through HARPTA. As Mr. Heller noted, when a nonresident sells the property, the fact that withholding occurs should alert the Department to check income tax and general excise tax filings regardless of whether an income tax return is subsequently filed or not. Mr. Roberts added that this is the reason why some have suggested that the HARPTA withholding rate be increased to cover both income tax and general excise tax.

Ms. Ching and Mr. Heller noted, however, that even if the Department did follow-up when there was HARPTA withholding, it may not be cost-effective for the Department to pursue a nonresident taxpayer unless the taxpayer had other Hawaii properties in Hawaii; especially, for example, foreign taxpayers such as a Japanese national who may only have had that one condo in Hawaii.

Decision was made to suggest that the Department do more education and enforcement in this area.

Ms. Niwao stated that the Department's computer system should automatically generate a letter when HARPTA withholding is received for a taxpayer with no filing record. Dr. Pham noted, however, that funding for additional improvements to the Department's computer system was not passed.

22. The S-Corporation tax form should be simplified.

Dr. Rousslang read the original suggestion 20, which was submitted anonymously. It suggested that a more detailed S-corporation income tax return be filed only when there are nonresident shareholders.

Ms. Niwao and the Chairman noted that this is not a problem for practitioners using software, though it is for those preparing returns manually.

As opposed to partnerships, nonresident shareholders of S-corporations must submit a form to the S-corporation stating that they will be filing a Hawaii return on their own; if not, the S-corporation withholds and remits payment on behalf of the nonresident shareholder to the State. It appears that this is the provision that the person making the suggestion believes is complicating the S-corporation tax return.

Ms. Nakamura stated that the Department is opposed to having multiple versions of the same form.

It was moved by Mr. Roberts and seconded by Ms. Ching that the Commission approve the recommendation that the S-Corporation form be simplified. Mr. Roberts noted that he was merely making a motion so that the proposal could be voted on. The motion failed with the following votes: 5-No.

The Chairman called for the vote:

Ronald Heller	No
John Roberts	No
Carolyn Ching	No
Christopher Grandy	No
Isaac Choy	No
Lon Okada	Absent

26. Private rulings, advice, and settlements by the Department should be made public the same as with IRS rulings.

TOGETHER WITH

27. Settlements of tax disputes should be made public.

Dr. Rousslang read the original suggestion 26 from Ray Kamikawa to conform Department practices to those of the IRS for reasons of transparency and "in order to ensure consistent and fair treatment for all, or at least promote the perception of same." Mr. Kamikawa also included settlement agreements "because the Department has used these agreements as a proxy for rulings."

Mr. Heller stated that suggestions 26 and 27 should be considered together as both refer to "settlements." Rulings and settlements are, however, two different issues. Settlements should remain confidential because that is the only way to resolve a dispute short of going to court where return information becomes public; if not confidential, taxpayers who go through the audit/settlement procedure will lose confidentiality merely because they don't agree 100% with the Department.

With respect to rulings, §231-19.5, HRS, discusses two kinds of rulings. "Written opinions" are public, but "determination letters" that merely apply established law are not public. The real issue is the classification of a ruling as either a written opinion or a determination letter. The Department has issued few written opinions, instead treating everything as a confidential determination letter. Ms. Nakamura agreed that this how it is, but she is not opposed to making public something akin to the IRS private letter rulings.

Mr. Heller was concerned that, even with redaction, it may not be possible to fully hide the identity of the taxpayer because Hawaii is a small town. Ms. Nakamura noted that IRS procedures allow taxpayers to submit what they would like as the redacted version.

Dr. Grandy suggested that the Commission, in its report, set out the basic values and urge the Department to move towards making more rulings public despite its tendency to protect privacy.

Ms. Nakamura stated that tax departments always lean towards confidentiality because of the criminal penalties for unauthorized disclosure and a concern about jeopardizing the self-assessing system if confidentiality is reduced or lost. She agrees that there is a difference between private letter rulings (what the Department thinks the correct interpretation of the law is) and settlements of audit cases (which involve the correct interpretation of the law, but also collectability issues, the facts of the case, litigation risks, etc.).

The Chairman noted that the suggestion is to conform with IRS practices, which would probably be easier.

Mr. Fritz observed that the IRS is set up to have people respond to ruling requests; for the State to do the same would require more structure. Backing up a little, he noted that the reimbursement rules for which there had been a hearing the previous day don't mention employee leasing, although an attachment to an employment leasing ruling describing what the factors are has been circulating amongst practitioners for a while, but not publicly. Having worked in the Department, he knows that additional laws, infrastructure, staffing, etc. will be needed.

Ms. Niwao asked why the Department couldn't do the same thing through Tax Information Releases. Mr. Heller agreed. The Department could put the guidance in Exhibit A of the employee leasing settlement agreement into a Tax Information Release. Mr. Fritz said that they could, but they haven't; part of the frustration people have is that the Department hasn't.

It was moved by Mr. Heller (for purposes of taking a vote) and seconded by Mr. Roberts that the Commission adopt suggestion 27, that settlements of tax disputes should be made public. The motion failed with the following votes: 4-No 1-Abstain.

The Chairman called for the vote:

Ronald Heller	No
John Roberts	No
Carolyn Ching	No
Christopher Grandy	Abstain
Isaac Choy	No
Lon Okada	Absent

With respect to suggestion 26, the Commission deleted "settlements" from the original suggestion and will ask the Department to re-examine the existing statute and consider ways to make more rulings public for the benefit of taxpayers generally.

28. Attorney General opinions and memos should be made public on a redacted basis.

Dr. Rousslang read the original suggestion 28 from Mr. Kamikawa. Although the Attorney General is the Department's attorney, Mr. Kamikawa suggested that opinions be made public "as a check on a secret law or favoritism." Mr. Kamikawa noted that many opinions issued were made public until a few years ago.

Mr. Heller agreed that many opinions issued were made public until a few years ago. He does not agree, however, that all Attorney General communications with the Department should be public, even on a redacted basis. The Attorney General is, in effect, the Department's attorney and can't function if confidential communications with its client are not permitted. He does not think the law needs to change; he does think that the attorney general's office needs to reconsider how often they issue opinions for the guidance of the public generally. Ms. Nakamura agreed with Mr. Heller.

Ms. Erickson noted that the statute provides for making opinions public; legal advice, however, is subject to the attorney-client privilege and is not public. Mr. Heller stated that even if legal advice is not public, the Attorney General could decide to write an opinion that could be made public.

Mr. Fritz noted that since the Department is the client, the Department could waive the attorney-client privilege and allow advice to become public. In some instances, auditors have told taxpayers that the Department had an opinion supporting the Department's position and then refused to release that opinion due to attorney-client privilege.

Mr. Roberts asked if things had been different under prior administrations. That was uncertain, but Mr. Fritz pointed out that there was substantially more guidance issued in the past through various Department publications including Tax Facts and newsletters than at present.

Before a vote was taken, Dr. Grandy asked if it would be reasonable to include in their report a discussion on this issue even if the suggestion was not approved; the issue needed to be addressed even if the approach to making more public guidance available was not decided. The Chairman encouraged all Commission members to contribute material on any matter they wished. Mr. Heller agreed that the Commission should encourage the release of more guidance to the public.

Mr. Fritz suggested that the Commission could include something to the effect that the Commission is concerned that the disclosure of every single Attorney General's opinion may interfere with the administration of tax law; however, they encourage, in situations where an opinion addresses general knowledge or sets forth certain general principles for all taxpayers, that the Attorney General consider providing it as public guidance.

It was moved by Mr. Heller and seconded by Ms. Ching to approve the suggestion that Attorney General opinions and memos should be made public on a redacted basis. The motion failed with the following votes: 5-No.

The Chairman called for the vote:

Ronald Heller	No
John Roberts	No
Carolyn Ching	No
Christopher Grandy	No
Isaac Choy	No
Lon Okada	Absent

29. Adopt IRC section 7430 on award of court fees where the taxpayer substantially prevails.

Dr. Rousslang read the original suggestion 28 from Mr. Kamikawa to adopt IRC 7430 regarding the awarding of court costs and fees where the taxpayer substantially prevails in any administrative or court proceeding if the government fails to prove that its position was

substantially justified. The intent is to ensure that the Department gives due consideration to the taxpayer's position and legal authority and to encourage the resolution of cases at an administrative or appeal level so that the taxpayer would not incur the costs of defense, as in a case in which the Department appealed an adverse decision by the Board of Review even though the weight of authority was in the taxpayer's favor.

Ms. Nakamura stated that the Department opposes this suggestion due to a concern about taxpayers drawing out the litigation and running up the bill. The Chairman noted that the IRS has a set dollar amount.

Mr. Heller added that it is an artificially low rate and should not be of concern with respect to the State's budget because the "not substantially justified" standard is very high; it is not enough to simply win the case. It is more the exception rather than the rule for a taxpayer to be awarded fees. It does force the government to seriously consider which cases to litigate all the way and which to settle.

Mr. Heller also suggested that the State replace the artificially low rate with the rate actually paid unless the court finds that it was excessive and unreasonable, by inserting the language, “actual court fees.”

Mr. Roberts observed that this measure appeared one-sided, in that it did not suggest that the taxpayer pay the State's fees in similar circumstances. Mr. Heller answered that there are federal sanctions if the taxpayer's case is frivolous. This provision does not apply until you actually appeal, but costs incurred in earlier stages could be considered by the court.

Dr. Grandy stated that this may not be an issue at the federal level given their resources, but the state’s limited resources would appear to be sufficient incentive for limiting the number of cases litigated. Mr. Fritz did not believe that to be necessarily true, because the longer litigation is drawn out, the better the State's chances of settlement. Mr. Heller added that he didn't think the State considered cost, as their attorneys are on salary. Ms. Nakamura pointed out that there were only a few attorneys to handle all the cases. Mr. Heller agreed, but said that they would just assign more cases and let them drag out in hopes of settling. He also noted that the Department is the client and it is up to the Department to decide what to litigate.

It was moved by Mr. Heller and seconded by Ms. Ching that the Commission adopt an amended suggestion that the State adopt IRC section 7430 on award of court fees where the taxpayer substantially prevails, except that the fees should be actual cost, subject to court approval. The motion was passed unopposed with the following votes: 6-Yes.

The Chairman called for the vote:

Ronald Heller	Yes
John Roberts	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes

Isaac Choy	Yes
Lon Okada	Yes

30. Establish an Appeals Office trained to settle cases.

Dr. Rousslang read the original suggestion 30 from Mr. Kamikawa. An appeals office, similar to the IRS Appeals Office, that answers directly to the Tax Director would be able to conduct a review of cases and settle the cases in a process totally independent and separate from the Compliance Division that conducted the audit and prepared the assessment. The staff should have special training in mediation and settlement, which the IRS may be able to accommodate.

Mr. Heller noted that, at the federal level, a very high percentage of cases, 80-85%, are settled at this level. He thinks it would be a good thing to have at the state level, but two things are needed, one of which was also mentioned by Mr. Kamikawa.

First, it would have to be a totally independent branch of the Department that reports to the Director of Taxation; it cannot be part of the audit branch (so that it will be able to disagree with the audit branch).

Second, it must be adequately staffed so the resolution of cases is not slowed down. There will be an added cost, but worth it in the long run for both the taxpayers and the Department.

Ms. Ching asked if going to the Appeals Office was mandatory at the federal level. Mr. Heller said that it was not mandatory, but that Tax Court judges usually referred the case back to the Appeals Office for a conference if a taxpayer went to court without going to Appeals first. Also, if taxpayers do not go through the Appeals Office, they are not able to recover their attorney fees later on because they did not use all means available to resolve their case.

Dr. Grandy asked if Hawaii had enough volume to warrant the creation of an appeals office, and if other states, especially those the size of Hawaii, have such an office. The Chairman noted that he is in favor of anything that gives the impression that the taxpayer is being afforded due process. Even at the federal level, he noted that staffing is insufficient and pointed out that the State has Boards of Review.

Mr. Heller, however, stated that they are totally different things. The Board of Review can decide a case; it makes an enforceable decision that is final unless appealed to a court. An appeals office cannot force a decision on anyone; it can only negotiate a settlement that both the taxpayer and the government agree on.

Dr. Grandy asked if the parties could just go through mediation instead of setting up an appeals office. Mr. Heller stated that, while in theory they could, it doesn't occur in practice because there is no mechanism in place to do so. He noted that he has a pending case for which he proposed getting a mediator, but it hasn't happened yet.

Dr. Rousslang stated that he thinks the Department may be too small for something like this. Mr. Roberts observed that the State has a tax system that apparently requires more bodies than it can afford, and though the Commission considered this issue early on, perhaps it needs another look.

Ms. Nakamura stated that, aside from the resources, finding people willing and able to do the job may be difficult. Dr. Pham added that the Department pays people much less than does the IRS, so after the Department trains them they go to the IRS. The Chairman asserted that the process must afford taxpayers as much due process as possible in the interest of fairness. Ms. Nakamura stated that legislators are willing to provide auditors because of the revenue generated, but the Department needs more front-end people to make the system fair.

It was moved by Ms. Ching and seconded by Mr. Heller that the Commission adopt the suggestion regarding the establishment of an Appeals Office trained to settle cases, modeled after the IRS' Appeals Office. The motion was passed with the following votes: 5-Yes 1-No.

The Chairman called for the vote:

Ronald Heller	Yes
John Roberts	Yes
Carolyn Ching	Yes
Christopher Grandy	No
Isaac Choy	Yes
Lon Okada	Yes

31. Mediation of audits – provide an alternative dispute resolution format.

Dr Rousslang read the original suggestion 31 from Mr. Kamikawa, who suggested that taxpayers be given the option of having their case decided in an alternative dispute resolution format such as mediation or arbitration.

Mr. Heller noted that mediation and arbitration are different. Mediation is a voluntary process that both parties must agree to. Disagreements could be mediated as long as both the taxpayer and the Department agree; it could happen now, but there is no mechanism for doing so. There is a serious problem with arbitration because it involves surrendering government authority and could be unconstitutional. Alternative dispute resolution should include mediation but should not include arbitration, and he doesn't think changes to the law are required.

The Chairman noted that Ms. Nakamura had submitted a statement saying that mediation is currently being done, although Mr. Heller noted that it hasn't been done in his experience, citing his request for mediation in the case discussed earlier. Ms. Nakamura does not have a problem with having both an appeals office and a mediation option, but feels that mediation would not be necessary if there was a good appeals office. Mr. Heller agreed, but thinks that mediation with an outside mediator could still be an option even if there was an appeals office.

No vote on this issue was taken since mediation already is an option. Dr. Grandy suggested that the report note that this was a suggestion and that it is currently available.

Mr. Smyth asked if taxpayers could now take it to the Mediation Center of the Pacific and if that is the kind of mediation the Department is currently doing. He explained that his Department has some experience with respect to the Small Business Review Board, and has found that there has been resistance on the part of other government agencies to go to mediation on regulatory issues. Mr. Heller noted that, by definition, mediation is voluntary and hinges on whether the Department agrees or not, and any of the available mediation companies could be used.

The Chairman asked if a Tax Information Release has already addressed this issue, and if not, if there would be one. Ms. Nakamura stated that she didn't think so. Mr. Okada asked if mediation procedures had been implemented; there currently are no procedures in place for mediation.

The Chairman asked what Ms. Nakamura meant by "forced mediation is unworkable" in her written statement. Ms. Nakamura explained that "forced mediation" refers to arbitration rather than mediation. Mr. Heller explained that mediation, by definition, is voluntary and cannot be forced, notwithstanding the fact that some judges will order the parties to mediation, though such efforts are often unsuccessful.

The Chairman asked if one would go to mediation prior to going before the Board of Review. Mr. Heller said that mediation would be done prior to going before the Board of Review, because if you settle there is no need to go further.

It was reaffirmed that no vote would be taken on this issue since mediation is already available.

32. Board of Review cases should be posted.

Dr. Rousslang read the original suggestion 32 from Mr. Kamikawa. He wrote that the Boards of Review handle a variety of cases, and the hearings should be open to the public both to ensure transparency and to provide guidance on important issues. Therefore, notices of the cases and the hearing dates and times should be posted on the Department's website.

Mr. Heller stated that the hearings, by statute, are technically public hearings, but have actually been secret in as much as nobody knows about them. In 25 years, he can't recall a case where there were spectators. He thinks there should be some venue for having a case decided where a taxpayer's returns remain confidential; the Boards of Review sort of serve that function. He would prefer that the statute be changed to delete the requirement that it be a public hearing. However, if it is a public hearing, then there should be some way of letting the public know that a hearing has been scheduled.

The Chairman asked if the Board of Review minutes would reflect what transpired, but no minutes are taken. After the fact, there is a decision, but the decisions are not published. Furthermore, the decisions are not usually helpful because it is just the bottom line number; one

page that says the taxpayer owes $X. Explanations of the issues and analyses of the reasoning are not provided.

Ms. Niwao asked if these hearings were subject to the sunshine law. Ms. Erickson stated that she would have to check the statute; it may not be if it is considered a quasi-judicial function. Mr. Heller thinks that is a judicial function because they are deciding cases.

Several questions were asked about what happens in a Board of Review hearing. Mr. Heller explained that what typically happens is that the taxpayer presents witnesses, etc., the Department responds, and then everyone leaves. The Board internally decides what they are going to do and then renders a decision; that internal discussion is not public and is not published in any minutes. A brief does not have to be submitted before the taxpayer goes into the hearing, though one typically is submitted. Whether a decision is rendered immediately or later depends on who is on the Board. It used to be that the Board would thank everyone and mail the decision a few weeks later. Since Mr. Richard Kahle, Jr., has been chair, decisions are frequently made in 30 minutes or so.

Mr. Fritz commented that there nonetheless is a written record of the decision, and that the decision may in some cases go beyond just a number. To the extent that it is a public record, and to the extent that it could be published, and to the extent that it might contain some useful information, there is no reason why it shouldn't it be made public.

Dr. Grandy stated that it seems that taxpayers need to have at least one level above the meeting with the auditor to have conflict resolution in a private setting. Mr. Fritz stated that, privacy doesn't really exist if anyone can go down and search through the decisions.

The Commission decided to vote on the original suggestion and also on an alternative proposal, 32a, to repeal the public nature of Board of Review cases.

It was moved by Dr. Grandy and seconded by Mr. Okada that the Commission adopt the suggestion that Board of Review cases should be posted on the Department's website. The motion failed with the following votes: 1-Yes 5-No.

The Chairman called for the vote:

Ronald Heller	No
John Roberts	No
Carolyn Ching	No
Christopher Grandy	Yes
Isaac Choy	No
Lon Okada	No

It was moved by Mr. Heller and seconded by Mr. Roberts that the Commission adopt alternative proposal 32a to repeal the statement in section 232-7, HRS, that says hearings before the Board of Review are public hearings. The motion passed with the following votes: 4-Yes 2-No.

The Chairman called for the vote:

Ronald Heller	Yes
John Roberts	Yes
Carolyn Ching	No
Christopher Grandy	No
Isaac Choy	Yes
Lon Okada	Yes

33. The burden of proof in court proceedings should conform to IRC section 7491.

Dr. Rousslang read the original suggestion 33 from Mr. Kamikawa. Although the burden of proof correctly rests with the taxpayer, that burden should shift to the Department once the taxpayer introduces credible evidence on any factual issue.

Mr. Heller agrees with Mr. Kamikawa, but feels that this should be given a low priority. At the federal level, it is not really useful because the court generally ignores that argument and just decides according to what they see as right.

Ms. Nakamura thinks the law is fine the way it is. The problem with this provision is determining what is credible evidence. Mr. Heller added that determining what is sufficient credible evidence is also problematic. The court has to decide what is credible and what is sufficient. Basically, if you convince the judge that you're right, you win; if you don't convince the judge that you're right, you lose. Talking about burden of proof is mostly a waste of time.

It was moved by Ms. Ching and seconded by Mr. Okada that the Commission approve the suggestion that the burden of proof in court proceedings should conform to IRC section 7491. The motion failed with the following votes: 3-Yes 1-No 2-Abstain.

The Chairman called for the vote:

Ronald Heller	Abstain
John Roberts	Yes
Carolyn Ching	No
Christopher Grandy	Abstain
Isaac Choy	Yes
Lon Okada	Yes

34. The taxpayer or a representative should have the right to participate in interviews with witnesses that are conducted as part of an audit.

Dr. Rousslang read the original suggestion 34 from Mr. Kamikawa. The reason taxpayers and their representatives should be given advance notice of an interview and the right to participate

in an interview or communication with third parties is to ensure that witness questions are fairly and impartially framed and that intimidation does not occur.

It was noted that there was an error in the agenda listing which read in the original, "The taxpayer of a representative should have the right to participate in interviews of witnesses that are conducted as part of an audit." The third word of this sentence should be "or" rather than "of."

Mr. Heller thinks that this goes too far and could hamper the Department in conducting audits. The IRS just has to give the taxpayer a general notice that it may contact unnamed third-parties. The taxpayer does not have the right to participate in or be present at those meetings. After contact has been made, the taxpayer can ask for the names of those the IRS actually spoke to, but not what was asked. If the IRS issues a formal summons for questioning under oath, the taxpayer must be notified within 3 days. The normal response time to a summons is 23 days, leaving 20 days for the taxpayer to quash the summons. These procedures are a reasonable compromise, which the State could adopt. He doesn't see a big systemic problem at the federal level.

Ms. Nakamura concurred. The Department feels that intimidation by the taxpayer could also occur. If the auditor wanted to interview an employee of the taxpayer, for example, the employee may not be able to be forthcoming if the employer is sitting there. It was noted that the taxpayer would have the opportunity to cross-examine the employee if the case went to court.

It was moved by Dr. Grandy and seconded by Mr. Heller that the Commission approve the suggestion that the taxpayer or a representative should have the right to participate in interviews of witnesses that are conducted as part of an audit. The motion failed with the following votes: 6-No.

The Chairman called for the vote:

Ronald Heller	No
John Roberts	No
Carolyn Ching	No
Christopher Grandy	No
Isaac Choy	No
Lon Okada	No

35. The Department of Taxation should review the certification process for the high tech credit – it now comes in the middle of the year.

The Chairman noted that this is more an administrative matter.

Ms. Nakamura said that the reason that it comes in the middle of the tax season is because, although the taxpayer could file the application anytime after the tax year ends, the statute specifies a March 30 due date, which cannot be extended, to allow time to get the certification

back to the taxpayer before the due date of the return (April 20 for a calendar year taxpayer). It would be odd to pick a date after the due date.

Mr. Fritz suggested looking at the process itself. Washington doesn't have a certification but a reporting requirement. And since the Hawaii certification may not hold up under audit, Hawaii may consider relieving the burden on the Department and change its certification requirement to an information-gathering tool rather than an actual certification.

The Chairman stated that this suggestion is merely asking for a review of the process, so no vote needs to be taken. Mr. Fritz noted that the current process is very burdensome on the Rules Office, so looking at whether the certification process should be changed into an information-gathering tool should be considered. Ms. Nakamura concurred that this is a big burden on the Rules Office, and makes it hard for that office to issue guidance on other matters.

Mr. Roberts suggested deferring this till later. It is being addressed in an external study, and if that study reveals that the cost-benefits cannot be property determined due to a lack of information, this and other informational issues could be addressed at the same time.

The Committee decided to defer this until a later date.

36. The Department of Taxation's procedures for processing EFT payments for "new business" should be evaluated.

Dr. Rousslang read the original suggestion submitted by Ms. Stacey Hadano, who stated that the Department had not upgraded its ACH Debit payment system to allow taxpayers with the new W-number to make their payments by EFT (only taxpayers who had previously assigned the "old" 8-digit identification number could do so).

Ms. Nakamura stated that her understanding is that this problem was corrected.

Because this issue has already been resolved by the Department, no vote was necessary.

LIST AGENDA ITEMS FOR THE NEXT MEETING

Dr. Rousslang will select another 15 suggestions for discussion at the next meeting.

The Chairman reminded the members that they should start drafting anything that they want included in the report.

Mr. Roberts asked the Commission to consider giving the State a report card on tax policy. While it might cause the Department to take note, it also could distract the Department from addressing more important things.

Mr. Smyth mentioned that the U.S. Supreme Court had decided the *DaimlerChrysler Corp. v. Cuno* case. The Court ruled that the taxpayer plaintiffs in this case had no standing to challenge the credits given to DaimlerChrysler Corp. This case was of interest to those like himself who had an interest in providing tax incentives, although the issue of the constitutionality of limiting tax credits to activities conducted within the state was not addressed.

The next Tax Review Commission meeting will be on June 27, 2006, at 9:00 a.m.

ADJOURNMENT

It was moved by Dr. Grandy and seconded by Ms. Ching to adjourn the meeting at 12:05 p.m. The motion was carried unanimously.