

DEPARTMENT OF TAXATION STATE OF HAWAII



ANNUAL REPORT 2013–2014

DEPARTMENT OF TAXATION

VISION

"The Department of Taxation will efficiently and effectively collect the revenue for funding programs and services for the people of Hawaii."

MISSION

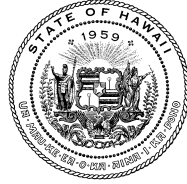
"Our mission is to administer the tax laws for the State of Hawaii in a consistent, fair and uniform manner."

GOALS

1. To *"Increase Voluntary Compliance"* by improving approaches to
 - a. Facilitate Filing/Paying for Compliant Taxpayers
 - b. Resolve Underlying Issues for Non-compliance
 - c. Proactive Approach to Educate New Filers
2. To *"Improve Processing,"* which will be accomplished in three ways
 - a. Redesign Business Processes
 - b. Expand Electronic Services
 - c. Modernize Tax Systems
3. To *"Enhance Quality Driven Productivity"* covering three areas
 - a. Develop Employees to Full Potential
 - b. Provide Resources – Internal and External (partnering)
 - c. Design/Utilize Management Information Reports

NEIL ABERCROMBIE
GOVERNOR

SHAN TSUTSUI
LT. GOVERNOR



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DIRECTOR OF TAXATION

TED S. SHIRAISHI
ACTING DEPUTY DIRECTOR

November 25, 2014

The Honorable Neil Abercrombie
Governor, State of Hawaii
Executive Chambers, State Capitol

Dear Governor Abercrombie:

Thank you for the opportunity to present you with the attached Annual Report summarizing the operations of the Department of Taxation (DOTAX) for the fiscal year (FY) ending June 30, 2014. DOTAX collected \$6.24 billion in taxes in FY 2014, or 95% of the \$6.58 billion that was collected from all taxes administered by the State. Last year, DOTAX collected \$6.23 billion in taxes, or 95% of the State's total tax collections of \$6.54 billion. The General Excise Tax (GET) is Hawaii's largest source of revenue and accounted for 44% of the State's total tax collections in FY 2014. Revenue from the GET declined to \$2.88 billion in FY 2014 from \$2.94 billion in FY2013, a drop of 2%. Revenue from Hawaii's Individual Income Tax (IIT), Hawaii's second largest tax, was \$1.75 billion in FY 2014, up slightly from \$1.74 billion in FY 2013. The IIT accounted for 27% of the State's total tax collections in FY 2014.

DOTAX has continued efforts to improve our manual processes and to determine the business requirements for our Tax Systems Modernization (TSM) project. TSM will come with a completely new computer system to replace our outdated system. TSM is a multi-year project that will help taxpayers comply with tax laws by expanding electronic services, allowing them to file all tax returns and to make all payments electronically. The project will also automate the licensing, tax clearance and compliance processes.

We recognized that taxpayers may fall out of compliance if they are not promptly served when they have questions about filing or paying their taxes. Our call answer rate (the percentage of incoming calls that are answered) had fallen from 80% in FY 2009 to 61% in FY 2010 and to 40% in FY 2011. We were able to improve the answer rate to 56% in FY 2012 and to 59% in FY 2013, but the answer rate fell to 42% in FY 2014. The Customer Inquiry Section still has many unfilled positions. We continue to strive to improve operations that were significantly impaired by the staffing reductions of FY 2009-2011. The 43 abolished positions and 59 frozen positions represented a 26% reduction in available staff hours and resulted in a significant backlog of work. The furloughs of 36 days also contributed to a backlog of work especially in the documents processing section where tasks are very labor intensive. We have been actively recruiting to fill positions, but the vacancy rate remains high, because many of our employees are eligible to retire and employees in lower grades seek positions with higher compensation.

We have focused on shortening the processing time for clearing check payments. In December 2010, a major Hawaii business magazine reported that taxpayers complained that DOTAX was taking up to two months to process checks. In response, we reviewed our processes and changed priorities. The new processes were put in place in April of 2011. Since then, most tax return processing is completed within two weeks and our monetary control section aims to process payments within 4 days of receipt. Now, about one quarter of payments are cashiered within 3 working days, up from 14% in FY 2011.

For future processing, we are working to encourage the public to change from mailing paper tax returns and checks to electronically filing returns and making electronic fund transfers. Electronic filing began with 140,000 electronically filed documents in FY 2004 and increased to 1,530,000 in FY 2013 and 1,690,000 in FY 2014. As a percentage of all documents filed, e-filing has increased from 30% in FY 2012 to 41% in FY 2013 and to 42% in FY 2014. The percentage of e-payments in total payment amounts has continued to increase, rising from 72% in FY 2013 to 73% in FY 2014. Our objective is to expand electronic filing to all 13 revenue sources and 27 types of tax returns as part of our TSM project.

Our Compliance Division also continued to operate under challenging conditions after the FY 2009-2011 staffing reductions, but it was able to increase both the number of cases audited and the amount of assessments in FY 2014. The total number of completed audit cases grew from 7,701 cases in FY 2013 to 9,202 cases in FY 2014, while the amounts assessed grew from \$87 million to \$99 million. In addition, our compliance staff continued to audit internet transactions of Online Travel Companies and issued additional assessments totaling \$217 million in FY 2014. These cases have been appealed to the Courts and are being handled by outside counsel.

Since the hiring freeze was lifted, section heads have focused on filling vacant positions in order to increase assessments and to collect additional tax revenue. We have arranged training to help our staff audit cross-border transactions and handle questions on nexus. Our compliance staff currently audits about 1% of total taxpayer accounts, but the strategic plan is to increase compliance efforts through market segment specialization to cover 2% to 3% of the total taxpayer population. This will be accomplished partly by expanding the staff and partly by using technology (the TSM project) to improve audit selection.

In summary, although DOTAX's operations have continued to suffer from the reduction in staffing that happened in FY's 2009 through 2011 and from the accompanying budget cuts; we have made great strides towards transforming the operations of the department since 2011.

- In 2011, we introduced the Department's first comprehensive strategic plan including vision statement, mission, goals, objectives and values. It is referred to as the **"2020 VISION"** plan, because employees are identifying areas for improvement which are being implemented and will be completed by the year 2020.
- In 2011, we issued the department's first assessment of the general excise tax on internet sales transactions. We have arranged for the Multi-State Tax Commission to provide training on cross border issues including Corporate Audits and Nexus training.
- In 2011, we began our Tax Systems Modernization project after concluding the contract with the prior computer vendor. In subsequent years, we identified the business requirements for the new system and we issued the Request for Procurement in FY2014. We expect to enter into a contract in FY2015.

Since 2011, much progress has been made towards achieving our strategic goals of increased voluntary compliance, improved processing and enhanced productivity. I am proud to report that DOTAX's employees have continued to become more efficient and more effective in collecting the revenue that our State government needs to provide the services and programs that are essential for maintaining the quality of life in Hawaii.

Sincerely,

/s/

FREDERICK D. PABLO
Director of Taxation

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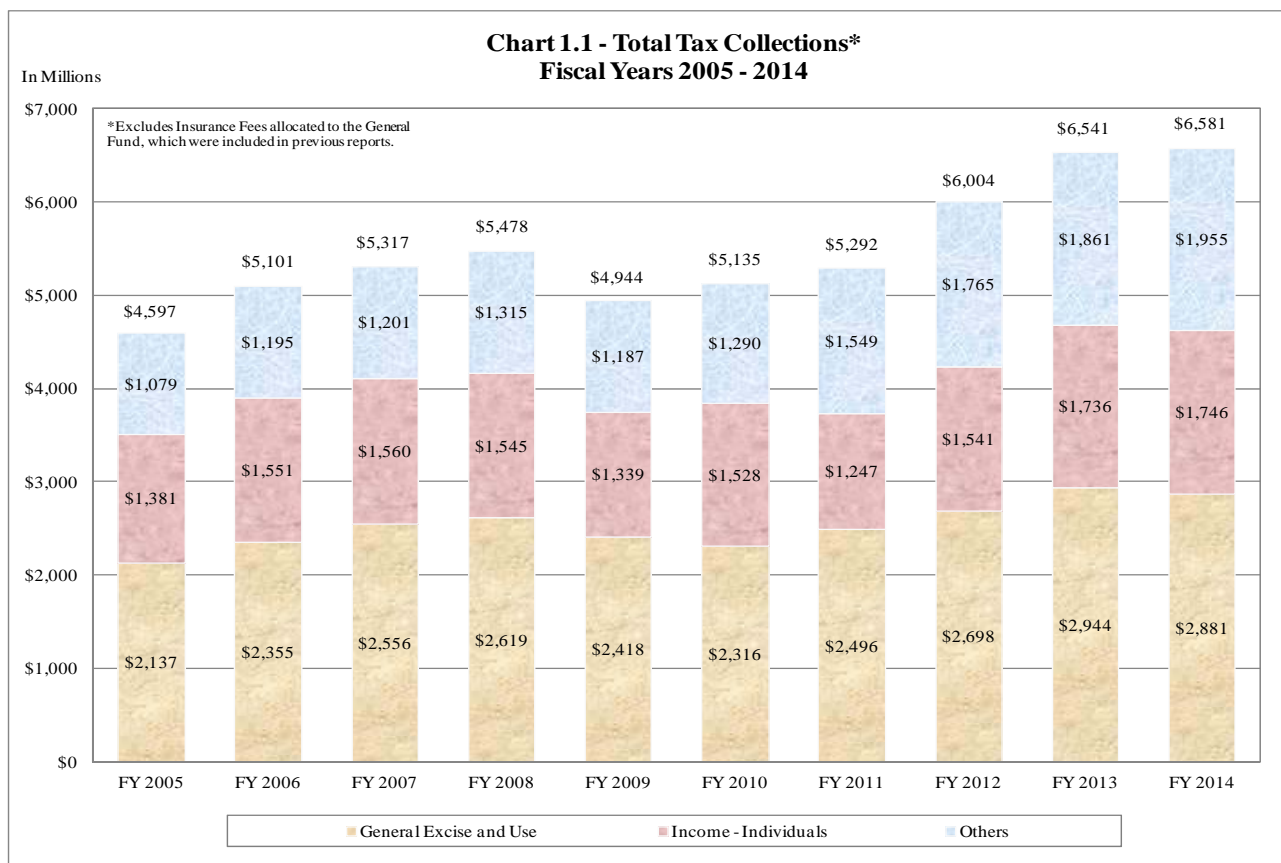
1.0 COLLECTION AND DISTRIBUTION OF TAXES

1.1 OVERVIEW

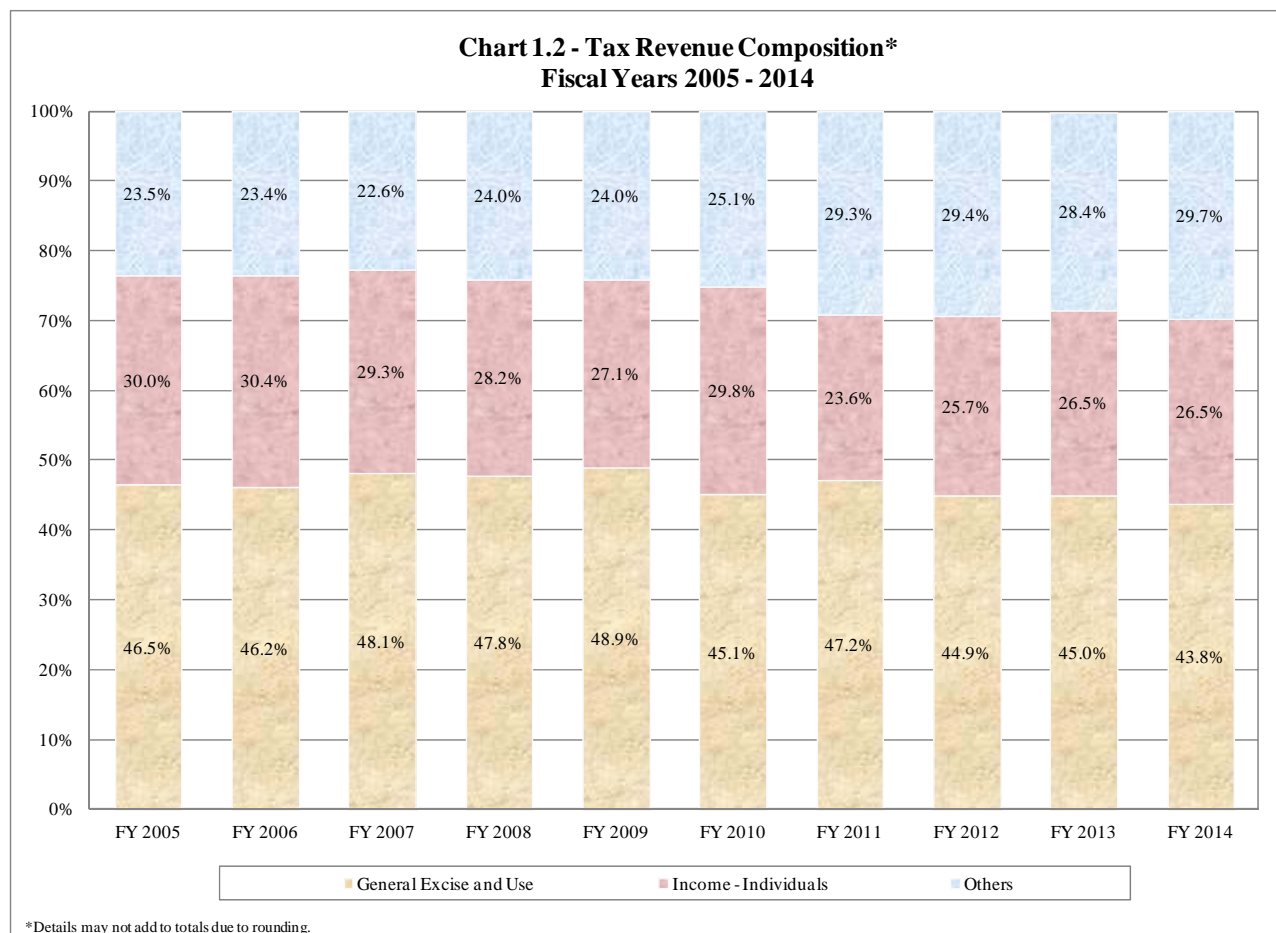
The Department of Taxation collects the revenues from most of the various taxes imposed by the State. In addition, the Department collects the County Surcharge imposed by the City and County of Honolulu and fuel taxes imposed by the counties. In fiscal year (FY) 2014, the Department collected a total of \$6.24 billion in net tax revenues, up just slightly from \$6.23 billion that was collected in FY 2013.

The Department's Office of Tax Research and Planning (TRP) tracks revenues from the taxes collected by the Department, and also from taxes that are administered by the State, but that are collected by other State agencies or by the counties. Henceforth, revenues from the taxes tracked by TRP will be referred to as "total tax collections."

Total tax collections were \$6.58 billion in FY 2014, up slightly from \$6.54 billion in FY 2013. In FY 2009, Hawaii experienced a decline in total tax collections as the Great Recession reduced incomes and spending of consumers and businesses. Since then, total tax collections have risen steadily due to temporary tax measures, an improving economy, and better tax administration. Chart 1.1 shows the main components of the total tax collections for FY's 2005 through 2014.



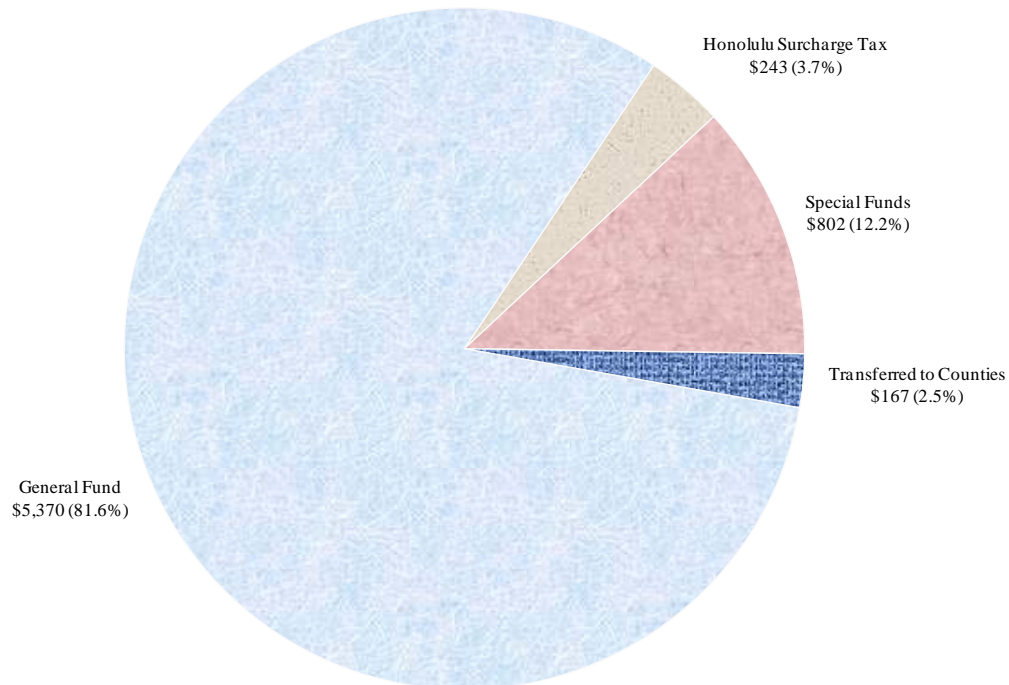
The State's biggest sources of tax revenue are the General Excise Tax (GET)¹ and the Individual Income Tax (IIT). In FY 2014, net GET collections amounted to \$2.88 billion and accounted for 43.8% of total tax collections, and net collections of the IIT amounted to \$1.75 billion and accounted for 26.5% of total tax collections. Chart 1.2 shows the shares of total tax collections accounted for by the GET and the IIT for FY's 2005 through 2014.



Of the total tax collections in FY 2014, \$5.37 billion, or 81.6% was deposited into the State's General Fund. The tax revenues deposited into the General Fund are used to pay most of the State's operating expenses. An additional \$409.7 million (6.2%) of the total tax collections was transferred to the counties, including transfers of the County Surcharge imposed by the City and County of Honolulu, fuel taxes imposed by the counties, and revenues from the Transient Accommodations Tax that were allocated to the counties. The remainder (\$801.5 million, or 12.2%) was transferred to various other State special funds. Chart 1.3 shows how the total tax collections were distributed in FY 2014.

¹ Throughout this report, the term "GET" will be used to include both the General Excise Tax and the Use Tax. The Use Tax complements the General Excise Tax and is levied on imports into the State from an unlicensed seller.

Chart 1.3 - Fiscal Year 2014 Distribution of Tax Revenues*
(In millions of dollars)



*Details may not add to totals due to rounding.

1.2 GENERAL EXCISE AND USE TAXES

1.2.1 Overview

Unlike the sales taxes imposed by many States and localities, Hawaii's GET is imposed on the business rather than on the customer. The GET covers virtually all forms of business activity, including services. Despite the relatively low tax rates, the GET generates substantial revenue, because the tax base is very broad.

The GET is imposed at the rate of 0.5% on wholesaling, wholesale services, producing, sugar processing and pineapple canning; at the rate of 0.15% on insurance commissions received by general agents, subagents and solicitors; and at the rate of 4.0% on most other activities, including retailing, business and professional services, contracting, theatre, amusement, radio, interest, commissions, and rentals. The fee for a GET license is a one-time charge of \$20.

1.2.2 Revenue

Revenue from the GET declined from \$2.94 billion in FY 2013 to \$2.88 billion in FY 2014, a drop of 2.2%. The results were mixed among the main components of the tax, but unallocated collections were unusually large in FY 2013 (\$188.9 million, compared to only \$19.9 million in FY 2014), so comparing revenues in the individual categories could give misleading results. Chart 1.4 shows the total revenues from the GET and from the tax levied on the various categories of income for FY's 2005 through 2014. Table 1.1 shows collections of the GET in greater detail for FY's 2013 and 2014.

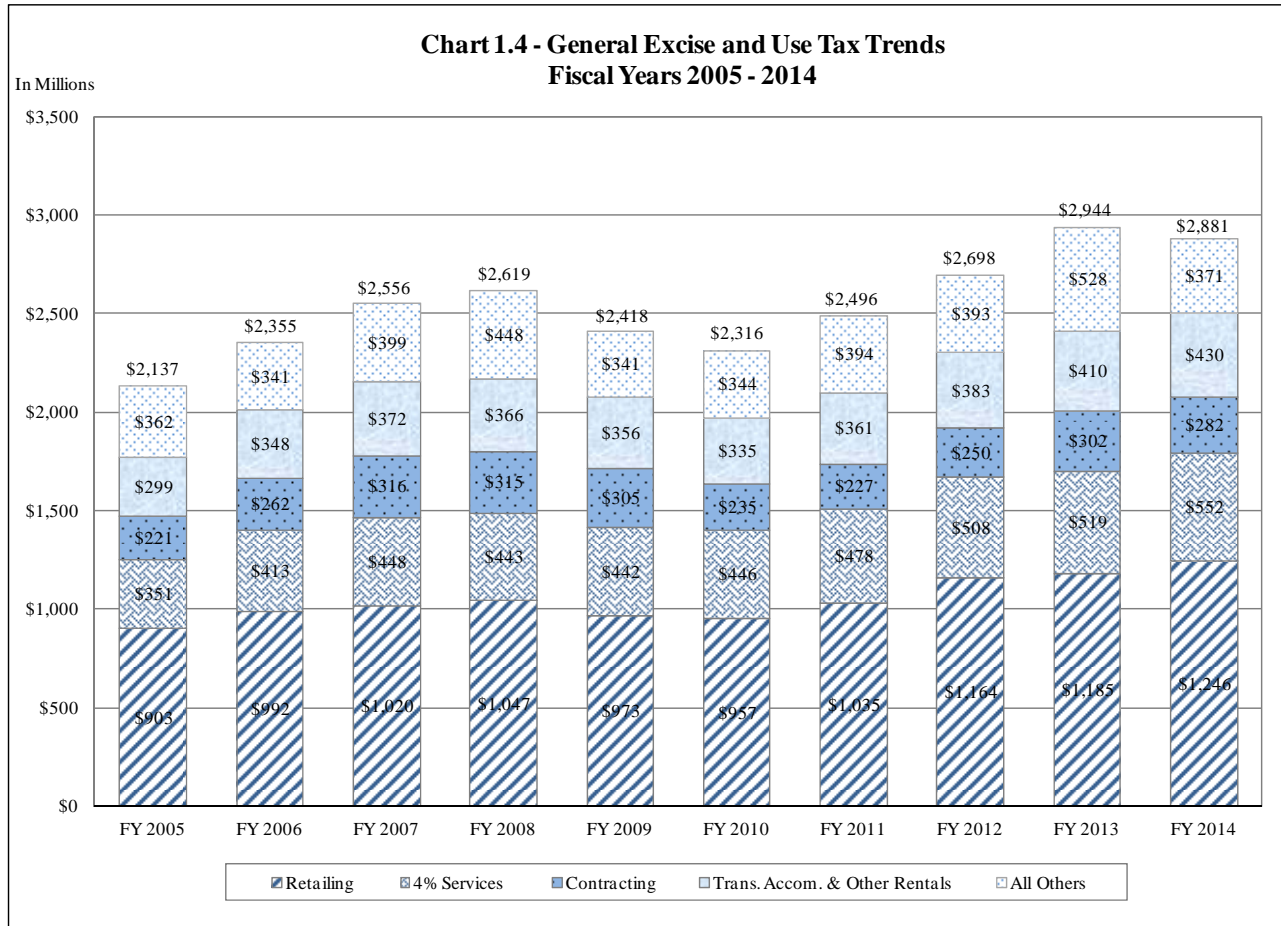


TABLE 1.1 - GENERAL EXCISE AND USE TAX BASE AND TAXES
FOR FISCAL YEARS ENDING JUNE 30, 2014 AND 2013
(In Thousands of Dollars)

| SOURCE OF REVENUE | Rate | FY 2014 | FY 2013 | Difference | |
|------------------------|-------|---------------|---------------|--------------|----------|
| | | | | Amount | % Change |
| TAX BASE | | | | | |
| Retailing | | \$ 31,151,514 | \$ 29,636,156 | \$ 1,515,358 | 5.1 |
| Services | | 13,794,599 | 12,985,478 | 809,121 | 6.2 |
| Contracting | | 7,045,964 | 7,546,884 | (500,920) | (6.6) |
| Trans. Accom. Rentals | | 4,279,059 | 3,870,919 | 408,140 | 10.5 |
| All Other Rentals | | 6,472,143 | 6,376,847 | 95,296 | 1.5 |
| All Others (4%) | | 5,683,228 | 5,336,618 | 346,610 | 6.5 |
| Subtotal | | \$ 68,426,508 | \$ 65,752,903 | \$ 2,673,605 | 4.1 |
| Producing | | \$ 436,212 | \$ 399,431 | \$ 36,781 | 9.2 |
| Manufacturing | | 1,876,030 | 638,782 | 1,237,248 | 193.7 |
| Wholesaling | | 14,674,581 | 14,429,710 | 244,870 | 1.7 |
| Use (1/2%) | | 6,489,198 | 8,867,289 | (2,378,091) | (26.8) |
| Wholesale Services | | 1,095,903 | 627,805 | 468,099 | 74.6 |
| Insurance Commissions | | 485,438 | 464,509 | 20,929 | 4.5 |
| Subtotal | | \$ 25,057,362 | \$ 25,427,525 | \$ (370,163) | (1.5) |
| TOTAL - ALL ACTIVITIES | | \$ 93,483,869 | \$ 91,180,428 | \$ 2,303,441 | 2.5 |
| TAX | | | | | |
| Retailing | 4.00% | \$ 1,246,061 | \$ 1,185,446 | \$ 60,614 | 5.1 |
| Services | 4.00% | 551,784 | 519,419 | 32,365 | 6.2 |
| Contracting | 4.00% | 281,839 | 301,875 | (20,037) | (6.6) |
| Trans. Accom. Rentals | 4.00% | 171,162 | 154,837 | 16,326 | 10.5 |
| All Other Rentals | 4.00% | 258,886 | 255,074 | 3,812 | 1.5 |
| All Others (4%) | 4.00% | 227,329 | 213,465 | 13,864 | 6.5 |
| Subtotal | | \$ 2,737,060 | \$ 2,630,116 | \$ 106,944 | 4.1 |
| Producing | 0.50% | \$ 2,181 | \$ 1,997 | \$ 184 | 9.2 |
| Manufacturing | 0.50% | 9,380 | 3,194 | 6,186 | 193.7 |
| Wholesaling | 0.50% | 73,373 | 72,149 | 1,224 | 1.7 |
| Use (1/2%) | 0.50% | 32,446 | 44,336 | (11,890) | (26.8) |
| Wholesale Services | 0.50% | 5,480 | 3,139 | 2,340 | 74.6 |
| Insurance Commissions | 0.15% | 728 | 697 | 31 | 4.5 |
| Subtotal | | \$ 123,588 | \$ 125,512 | \$ (1,924) | (1.5) |
| Unallocated* | | \$ 19,893 | \$ 188,859 | \$ (168,966) | (89.5) |
| TOTAL - ALL ACTIVITIES | | \$ 2,880,541 | \$ 2,944,487 | \$ (63,946) | (2.2) |

* Includes collections from penalty and interest, assessments and corrections, delinquent collections, refunds, protested payments, settlements and business activities of disabled persons.

NOTE: Details may not add to totals due to rounding.

1.2.3 Recent Legislation

Act 160, SLH 2013, eliminates the GET exemption for liquor, tobacco and food sold to common carriers for taxable years beginning after December 31, 2013.

Act 163, SLH 2013, makes permanent the GET exemptions for common expenses paid by managers, sub-managers, and sub-operators and for hotel employee expenses paid by hotel operators and timeshare projects. The Act also eliminates the aggregate cap on the exempt amounts for taxable years beginning after December 31, 2012.

1.3 INDIVIDUAL INCOME TAX

1.3.1 Overview

Hawaii's Individual Income Tax (IIT) generally follows the federal definitions for determining net taxable income, but it has its own exemptions, tax credits and tax rates. The IIT has twelve brackets, with tax rates ranging from 1.4% to 11.0%.

1.3.2 Revenue

The IIT is the State's second biggest source of tax revenue. The biggest part of the IIT collections is taxes withheld on employee wages. In FY 2014, withholding tax collections were \$1.62 billion, an increase of 4.0% over the \$1.56 billion withheld in FY 2013. Total IIT refunds in FY 2014 were \$478.3 million, a \$35.8 million increase from FY 2013 refunds of \$442.5 million. The net IIT collections in FY 2014 were \$1.75 billion, a slight increase over the \$1.74 billion collected in FY 2013. Chart 1.5 shows total collections of the IIT, along with wage withholding, payments with returns, and refunds, for FY's 2005 through 2014. Table 1.2 shows the figures for total collections of the IIT, broken down by its components, in FY's 2013 and 2014.

1.3.3 Recent Legislation

Act 60, SLH 2009, raised the tax rates for single individuals with taxable incomes over \$150,000 and for married couples filing jointly with income over \$300,000 by adding new high-end tax brackets with marginal tax rates that range from 9% to 11%. Before Act 60, the highest income tax rate was 8.25%. The tax rate increases imposed by Act 60 are effective for taxable years beginning after December 31, 2008 and ending before January 1, 2015.

Act 97, SLH 2011, eliminates the deduction for state income taxes paid for individuals with federal adjusted gross income above specified thresholds. The Act also places temporary limits on claims for itemized tax deductions. The Act is effective for taxable years beginning after December 31, 2010, but the limits it imposes on itemized deductions expire December 31, 2015. The Act delayed the increases in the standard deduction and personal exemption that were approved under Act 60, SLH 2009 until taxable years beginning after December 31, 2012, and makes the increases permanent.

Act 256, SLH 2013, removed charitable deductions from the limits on itemized deductions that were imposed by Act 97, SLH 2011. Act 256 is effective for taxable years beginning after December 31, 2012.

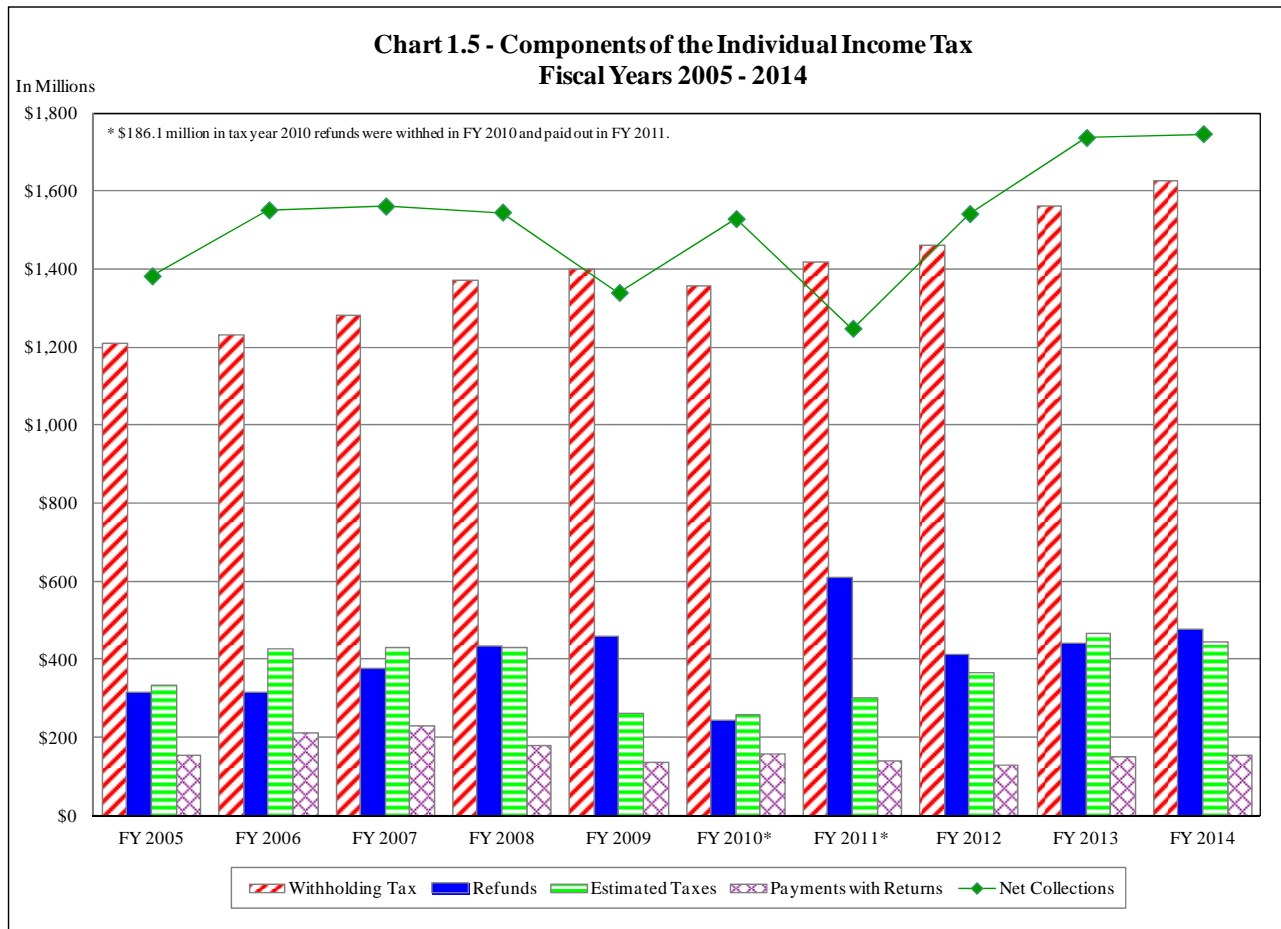


TABLE 1.2 - TAXES PAID BY INDIVIDUALS
(In Thousands of Dollars)

| | FY 2014 | FY 2013 | Difference | |
|--------------------------------|--------------|--------------|-------------|----------|
| | | | Amount | % Change |
| Declaration of Estimated Taxes | \$ 445,432 | \$ 466,936 | \$ (21,504) | (4.6) |
| Payment with Return | 153,649 | 149,277 | 4,372 | 2.9 |
| Withholding Tax on Wages | 1,624,994 | 1,562,326 | 62,668 | 4.0 |
| Subtotal | \$ 2,224,075 | \$ 2,178,539 | \$ 45,537 | 2.1 |
| Refunds | 478,265 | 442,532 | 35,734 | 8.1 |
| NET | \$ 1,745,810 | \$ 1,736,007 | \$ 9,803 | 0.6 |

NOTE: Due to rounding, details may not add to totals.

1.4 CORPORATE INCOME TAX

1.4.1 Overview

Hawaii's Corporate Income Tax (CIT) has three tax brackets. The brackets (and the corresponding tax rates) are as follows: 4.4% on taxable income up to \$25,000; 5.4% on taxable income over \$25,000 but not over \$100,000; and 6.4% on taxable income over \$100,000. The tax rate for corporate capital gains is 4%.

1.4.2 Revenue

Net CIT collections totaled \$87.0 million in FY 2014, a decline of 13.9% from the previous year's total of \$101.0 million. CIT collections are highly cyclical, but they are a relatively small part of Hawaii's total tax collections. In FY 2014, the CIT accounted for just 1.3% of total tax collections. Chart 1.6 shows total collections of the CIT, broken down by its components, for FY's 2005 through 2014. Table 1.3 shows data on collections of the CIT for FY's 2013 and 2014.

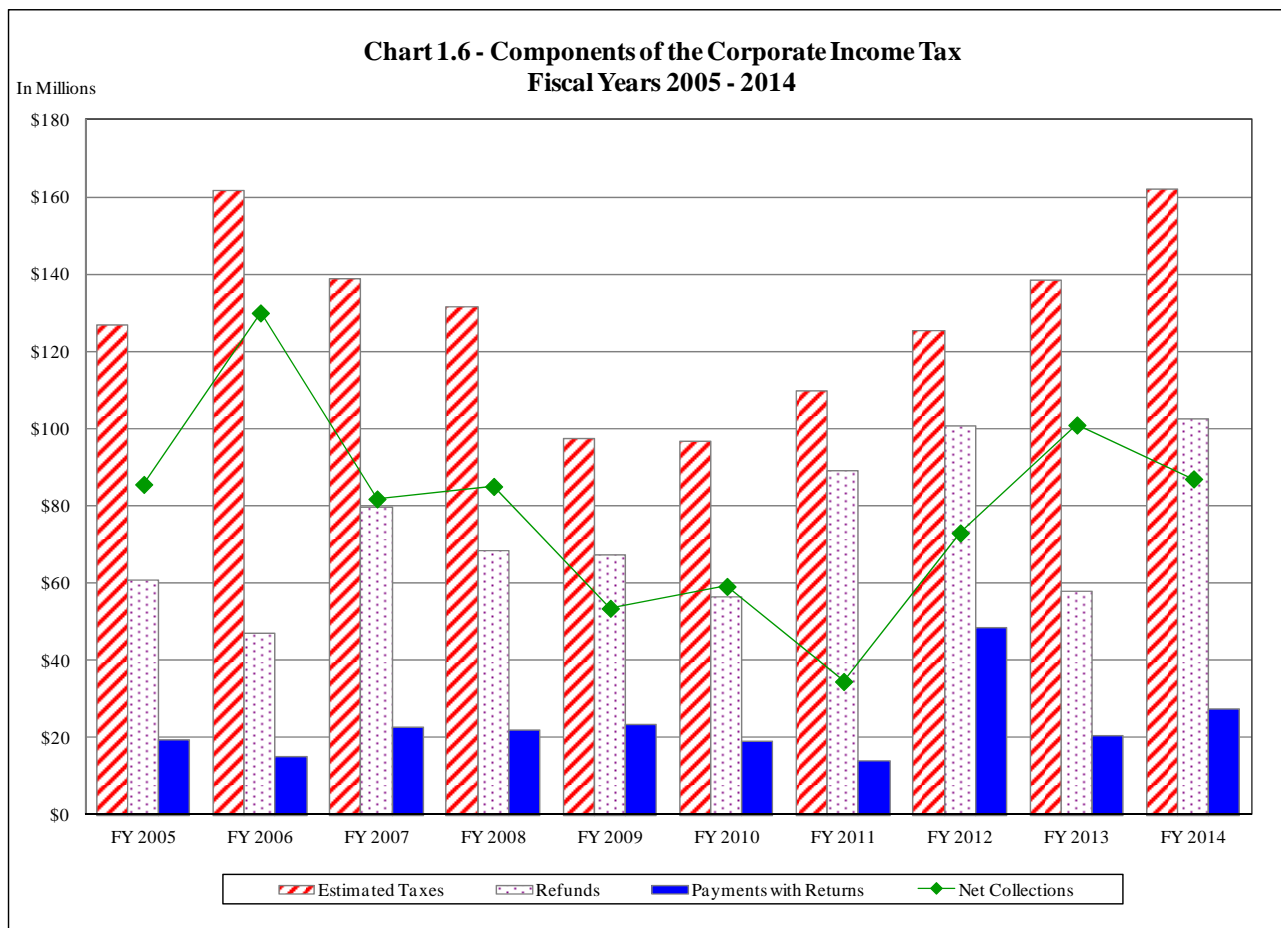


TABLE 1.3 - TAXES PAID BY CORPORATIONS
(In Thousands of Dollars)

| | FY 2014 | FY 2013 | Difference | |
|--------------------------------|------------|------------|-------------|----------|
| | | | Amount | % Change |
| Declaration of Estimated Taxes | \$ 162,041 | \$ 138,349 | \$ 23,692 | 17.1 |
| Payment with Return | 27,480 | 20,586 | 6,894 | 33.5 |
| Subtotal | \$ 189,521 | \$ 158,934 | \$ 30,587 | 19.2 |
| Refunds | 102,500 | 57,947 | 44,553 | 76.9 |
| NET | \$ 87,021 | \$ 100,988 | \$ (13,967) | (13.8) |

NOTE: Due to rounding, details may not add to totals.

1.5 TRANSIENT ACCOMMODATIONS TAX

1.5.1 Overview

The Transient Accommodations Tax (TAT) is levied on the furnishing of a room, apartment, suite, or the like, which is customarily occupied by the transient for less than 180 consecutive days. The rate for the TAT has been 9.25% since July 1, 2010. The registration fee for transient accommodations operators is a one-time fee of \$5 for each registration consisting of 1 to 5 units and \$15 for each registration of 6 or more units. Plan managers of time share units pay TAT at the rate of 7.25% on the fair market rental value of the units.

1.5.2 Revenue

TAT collections totaled \$395.2 million for FY 2014, an increase of 7.2% from the \$368.6 million collected in FY 2013. In FY 2014, collections from the TAT were distributed as follows: \$93.0 million went to the counties; \$33.0 million went to the Convention Center Enterprise Special Fund; \$82.0 million went to the Tourism Special Fund; and the remainder (\$187.2 million) went to the General Fund. Chart 1.7 shows collections of the TAT for FY's 2005 through 2014. Chart 1.8 shows the allocations of the tax among the various funds. Table 1.4 shows TAT collections and allocations in FY's 2013 and 2014.

1.5.3 Recent Legislation

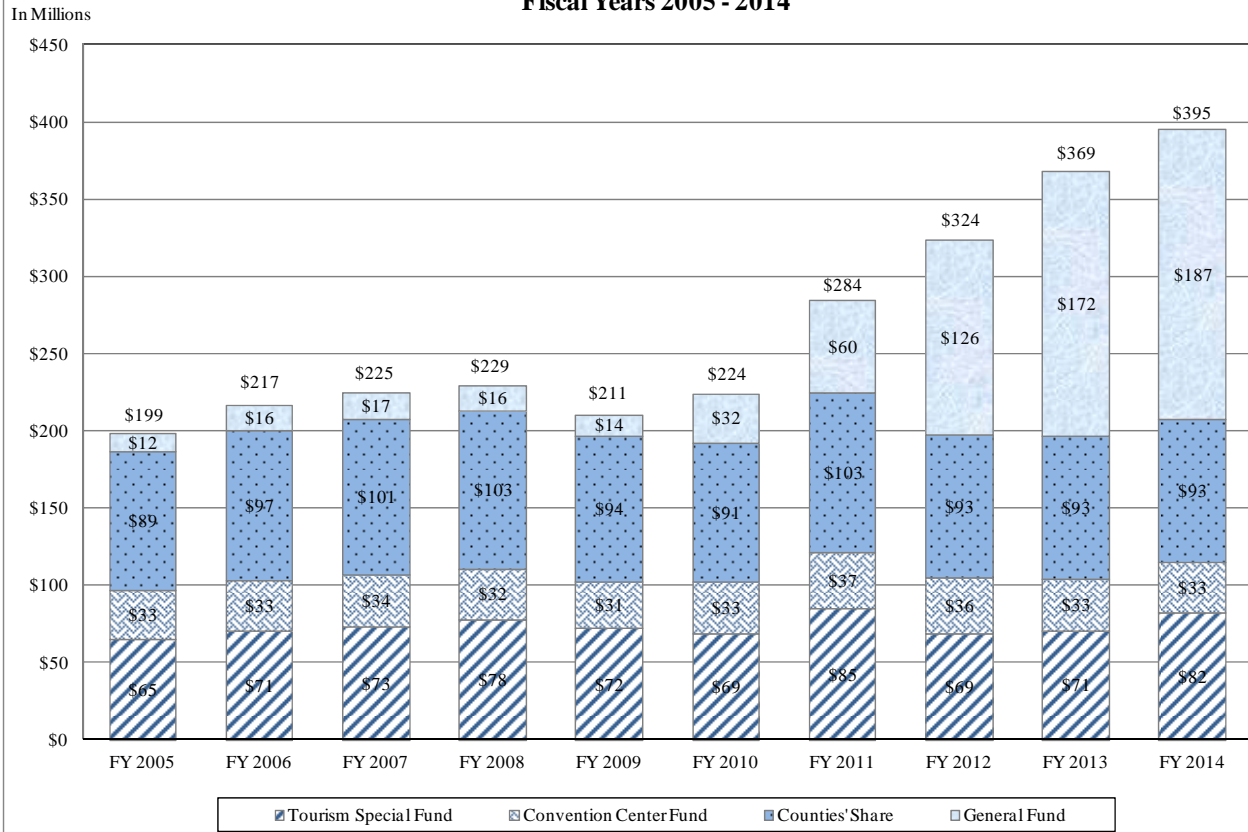
Act 161, SLH 2013, makes permanent the TAT rate of 9.25% and makes permanent the caps on allocations of the TAT for each fiscal year as follows: \$82 million to the Tourism Special Fund, \$93 million to the counties, and \$33 million to the Convention Center Enterprise Fund. (The TAT rate was scheduled to return to 7.25% on July 1, 2015 and the caps on allocations of the TAT to the counties and to the Tourism Special Fund were scheduled to expire on June 30, 2015. The previous caps were the same as those in Act 161, except that the cap on the Tourism Special Fund was \$71 million.) Act 161 also eliminated the \$10 daily TAT on each transient accommodation furnished on a complimentary basis that was imposed by Act 103, SLH 2011. Act 161 took effect July 1, 2013.

Act 81, SLH 2014 reduces allocations of the TAT to the Convention Center Special Fund from \$33 million to \$26.5 million annually and allocates \$3 million to the Turtle Bay Easement Special Fund. However, the new allocations mandated by the Act are not being made, owing to the "pending status" of the turtle Bay purchase.

Act 174, SLH 2014 increases allocations of the TAT to the counties from \$93 million to \$103 million per year for fiscal years 2015 and 2016.



**Chart 1.8 - Transient Accommodations Tax Distributions
Fiscal Years 2005 - 2014**



**TABLE 1.4 - TRANSIENT ACCOMMODATIONS TAX
(In Thousands of Dollars)**

| | FY 2014 | FY 2013 | Difference | |
|------------------------------------|------------|------------|------------|----------|
| | | | Amount | % Change |
| Collection | | | | |
| Trans. Accom./Time Share Occ. Tax | \$ 395,229 | \$ 368,556 | \$ 26,673 | 7.2 |
| Trans. Accom./Time Share Occ. Fees | 13 | 20 | (8) | (37.0) |
| Total | \$ 395,242 | \$ 368,576 | \$ 26,665 | 7.2 |
| Distribution* | | | | |
| Counties Share | \$ 93,000 | \$ 93,000 | \$ - | 0.0 |
| Convention Center Fund | 33,000 | 33,000 | - | 0.0 |
| Tourism Special Fund | 82,000 | 71,000 | 11,000 | 15.5 |
| General Fund | 187,242 | 171,576 | 15,665 | 9.1 |
| Total | \$ 395,242 | \$ 368,576 | \$ 26,665 | 7.2 |

*For detailed percentages of distribution see section 237D-6.5, HRS.

NOTE: Due to rounding, details may not add to totals.

1.6 FUEL TAXES

1.6.1 Overview

The State and county fuel taxes are imposed on the distributors. The State Legislature sets the State fuel tax rates, whereas county councils set the county rates. There is also an Environmental Response Tax (officially renamed as the "Environmental Response, Energy and Food Security Tax" by Act 73, SLH 2010) that is levied on each barrel of petroleum products. The effective rates for the fuel taxes and for the Environmental Response Tax in FY 2014 are shown on the following page.

1.6.2 Revenue

Fuel tax collections (not including the Environmental Response Tax) amounted to \$167.5 million in FY 2014, a slight increase over the \$166.8 million collected in FY 2013. Total taxable fuel consumption grew by 5.5% to 910.7 million gallons in FY 2014. The biggest consumption of taxable fuel was gasoline (449.0 million gallons, or 49.3% of total taxable fuel consumption in FY 2014). The second biggest consumption of taxable fuel was aviation fuel (240.5 million gallons, or 26.4% of total taxable consumption in FY 2014). Together, gasoline and aviation fuel accounted for 75.7% of the total consumption of taxable fuel in FY 2014.

Collections of the Environmental Response Tax amounted to \$26.0 million in FY 2013, a decline of 4% from the \$27.2 million collected in FY 2013. The Environmental Response Tax was imposed at the rate of \$1.05 on each barrel of petroleum product sold by a distributor to any retail dealer or end user. The tax was levied on 24.8 million barrels of petroleum in FY 2014, a decline of 4.3% from FY 2013. Chart 1.9 shows total combined collections of the fuel taxes and of the Environmental Response Tax, and the gallons consumed of the various fuel types, for FY's 2005 through 2014. Data for taxable gallons consumed for FY's 2013 and 2014 are given in Table 1.5.

The revenues from fuel taxes are distributed to several special funds. One percent of the fuel taxes paid on liquid fuel, not including aviation fuel, are deposited into the Boating Special Fund. Fuel taxes paid on sales of aviation fuel are deposited into the Airport Revenue Fund. Remaining revenues from the State fuel taxes are deposited into the State Highway Fund, whereas remaining revenues from county fuel taxes are deposited into the counties' highway funds.

Revenues from the Environmental Response Tax were distributed as follows in FY 2014: For each barrel taxed at \$1.05, 5 cents went to the Environmental Response Revolving Fund administered by the Department of Health for oil spill prevention and remediation programs; 15 cents went to the Energy Security Special Fund administered by the Department of Business, Economic Development, and Tourism to support the Hawaii clean energy initiative program; 15 cents went into the Food Security Special Fund administered by the Department of Agriculture to fund activities intended to increase agricultural production or processing that may lead to reduced importation of food, fodder, or feed from outside the state; and the remainder (75 cents per barrel) went to the General Fund.

FUEL TAX RATES PER GALLON*

| Type of Fuel | State | County | Total |
|--|---------|--------|---------|
| GASOLINE AND DIESEL OIL (HWY. USE) | | | |
| City & County of Honolulu | 17.0 ¢ | 16.5 ¢ | 33.5 ¢ |
| County of Maui | 17.0 | 16.0 | 33.0 |
| County of Hawaii | 17.0 | 8.8 | 25.8 |
| County of Kauai | 17.0 | 15.0 | 32.0 |
| LIQUID PETROLEUM GAS (HWY. USE) | | | |
| City & County of Honolulu | 5.2 ¢ | 5.4 ¢ | 10.6 ¢ |
| County of Maui | 5.2 | 4.3 | 9.5 |
| County of Hawaii | 5.2 | 2.9 | 8.1 |
| County of Kauai | 5.2 | 5.0 | 10.2 |
| ETHANOL (HWY. USE) | | | |
| City & County of Honolulu | 2.4 ¢ | 2.4 ¢ | 4.8 ¢ |
| County of Maui | 2.4 | 3.8 | 6.2 |
| County of Hawaii | 2.4 | 1.3 | 3.7 |
| County of Kauai | 2.4 | 2.2 | 4.6 |
| METHANOL (HWY. USE) | | | |
| City & County of Honolulu | 1.9 ¢ | 1.8 ¢ | 3.7 ¢ |
| County of Maui | 1.9 | 2.9 | 4.8 |
| County of Hawaii | 1.9 | 1.0 | 2.9 |
| County of Kauai | 1.9 | 1.7 | 3.6 |
| BIODIESEL (HWY. USE) | | | |
| City & County of Honolulu | 4.0 ¢ | 8.3 ¢ | 12.3 ¢ |
| County of Maui | 4.0 | 0.0 | 4.0 |
| County of Hawaii | 4.0 | 0.0 | 4.0 |
| County of Kauai | 4.0 | 0.0 | 4.0 |
| COMPRESSED NATURAL GAS (HWY. USE) | | | |
| City & County of Honolulu | 0.8 ¢ | 1.3 ¢ | 2.1 ¢ |
| County of Maui | 0.8 | 1.2 | 2.0 |
| County of Hawaii | 0.8 | 0.7 | 1.5 |
| County of Kauai | 0.8 | 1.1 | 1.9 |
| LIQUEFIED NATURAL GAS (HWY. USE) | | | |
| City & County of Honolulu | 2.4 ¢ | 4.7 ¢ | 7.1 ¢ |
| County of Maui | 2.4 | 4.5 | 6.9 |
| County of Hawaii | 2.4 | 2.5 | 4.9 |
| County of Kauai | 2.4 | 4.2 | 6.6 |
| ENVIRONMENTAL RESPONSE TAX (per barrel) | | | |
| All Counties | 105.0 ¢ | 0.0 ¢ | 105.0 ¢ |

*Gasoline used for agricultural equipment off highways is taxed by the State at 1¢ per gallon. Aviation fuel, diesel oil used off highways, and naphtha used in power generating facilities are taxed by the State at 2¢ per gallon.

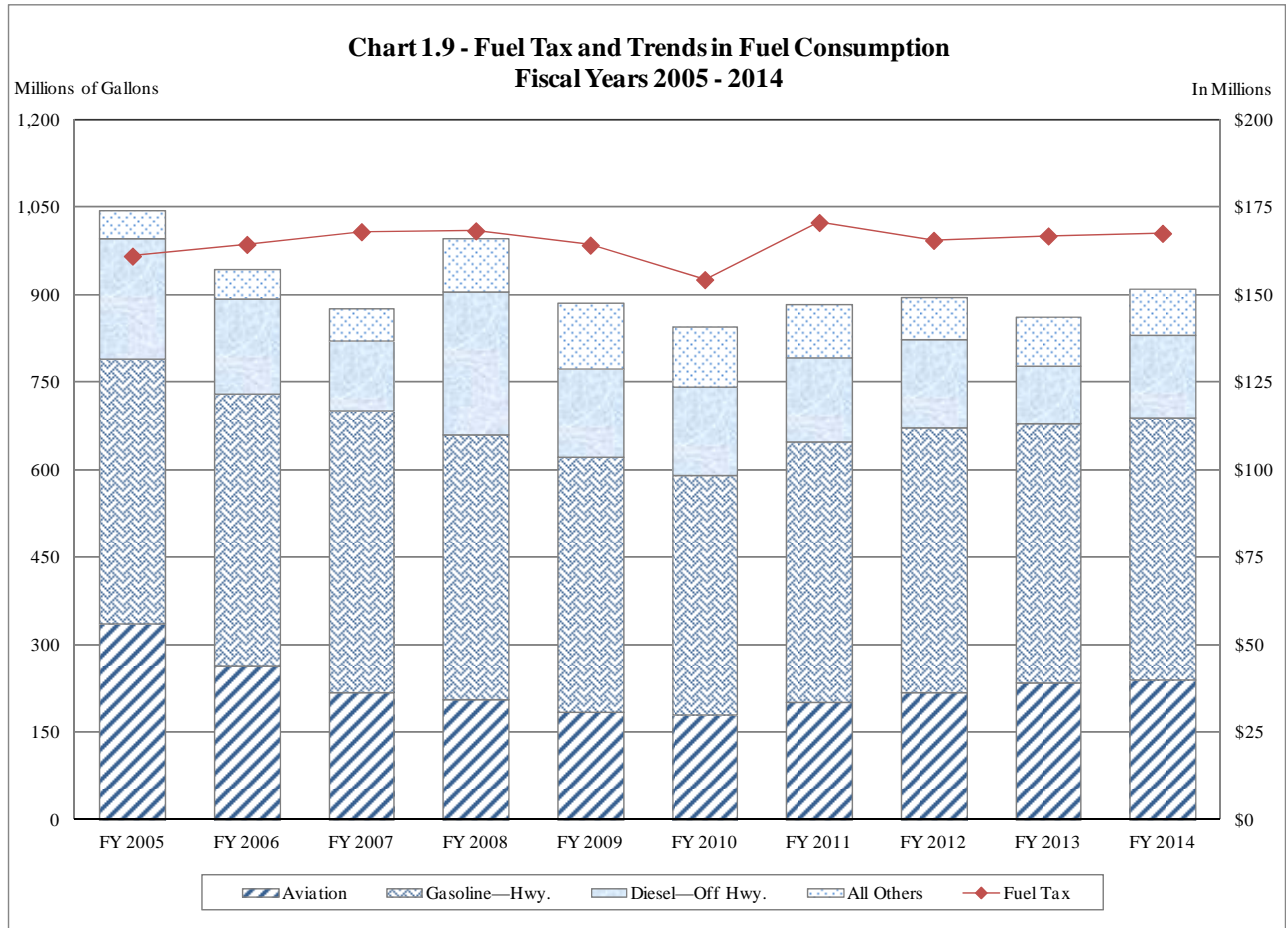


TABLE 1.5 - TAXABLE GALLONS OF FUEL CONSUMED
(In Thousands of Gallons)

| | FY 2014 | FY 2013 | Difference | |
|----------------------------|----------------|----------------|---------------|------------|
| | | | Amount | % Change |
| Gasoline | 449,028 | 443,138 | 5,890 | 1.3 |
| Diesel Oil - Off Highway | 142,132 | 100,087 | 42,045 | 42.0 |
| Diesel Oil - Highway | 46,542 | 51,613 | (5,070) | (9.8) |
| Liq. Pet. Gas - Highway | 24 | 26 | (2) | (6.5) |
| Small Boats - Gasoline | 1,560 | 1,170 | 390 | 33.4 |
| Small Boats - Diesel Oil | 2,170 | 511 | 1,659 | 324.7 |
| Aviation Fuel | 240,461 | 235,350 | 5,111 | 2.2 |
| Other Fuel * | 28,781 | 31,000 | (2,219) | (7.2) |
| Total Gallons | 910,700 | 862,894 | 47,805 | 5.5 |
| Environmental Tax (Barrel) | 24,795 | 25,895 | (1,100) | (4.2) |

* Other fuel includes ethanol, methanol, biodiesel, naphtha, compressed natural gas, and liquefied natural gas.

NOTE: Due to rounding, details may not add to totals.

Table 1.6 shows how the fuel taxes and the Environmental Response Tax were allocated in FY's 2013 and 2014. The table also shows allocations of the motor vehicle taxes and fees to the State Highway Fund.

TABLE 1.6 - ALLOCATION OF FUEL TAXES
(In Thousands of Dollars)

| | FY 2014 | FY 2013 | Difference | |
|---|------------|------------|------------|---------|
| | | | Amount | % |
| STATE HIGHWAY FUND | | | | |
| Gasoline | \$ 75,761 | \$ 74,684 | \$ 1,077 | 1.4 |
| Diesel Oil - Off Highway | 2,857 | 1,992 | 865 | 43.4 |
| Diesel Oil - Highway | 7,833 | 8,686 | (853) | (9.8) |
| Liq. Pet. Gas - Highway | 1 | 1 | (0) | (6.5) |
| Other Fuel | 627 | 661 | (34) | (5.1) |
| Subtotal | \$ 87,080 | \$ 86,025 | \$ 1,055 | 1.2 |
| Motor Vehicle | 125,873 | 124,183 | 1,689 | 1.4 |
| Rental Vehicle | 42,852 | 47,593 | (4,741) | (10.0) |
| TOTAL | \$ 255,805 | \$ 257,801 | \$ (1,997) | (0.8) |
| COUNTY HIGHWAY FUNDS | | | | |
| City & County of Honolulu | \$ 51,424 | \$ 53,825 | \$ (2,401) | (4.5) |
| County of Maui | 10,676 | 10,617 | 59 | 0.6 |
| County of Hawaii | 7,380 | 6,035 | 1,346 | 22.3 |
| County of Kauai | 4,519 | 3,930 | 589 | 15.0 |
| TOTAL | \$ 73,999 | \$ 74,407 | \$ (408) | (0.5) |
| BOATING SPECIAL FUND | \$ 1,627 | \$ 1,621 | \$ 7 | 0.4 |
| STATE AIRPORT FUND | | | | |
| Aviation Fuel | \$ 4,809 | \$ 4,707 | \$ 102 | 2.2 |
| ENVIRONMENTAL RESPONSE REVOLVING FUND | \$ 1,240 | \$ 1,295 | \$ (55) | (4.2) |
| ENERGY SECURITY FUND | \$ 3,719 | \$ 3,884 | \$ (165) | (4.2) |
| ENERGY SYSTEMS DEVELOPMENT FUND | \$ - | \$ 2,590 | \$ (2,590) | (100.0) |
| AGRICULTURAL DEVELOPMENT & FOOD SECURITY FUND | \$ 3,719 | \$ 3,884 | \$ (165) | (4.2) |
| GENERAL FUND | \$ 17,356 | \$ 15,537 | \$ 1,819 | 11.7 |

NOTE: Due to rounding, details may not add to totals.

1.6.3 Recent Legislation

Act 107, SLH 2014 reestablishes the Energy Systems Development Special Fund and extends the \$1.05 per barrel rate for the Environmental Response Tax through fiscal year 2030. (The tax rate was scheduled to go back to \$0.05 per barrel at the end of fiscal year 2015.)

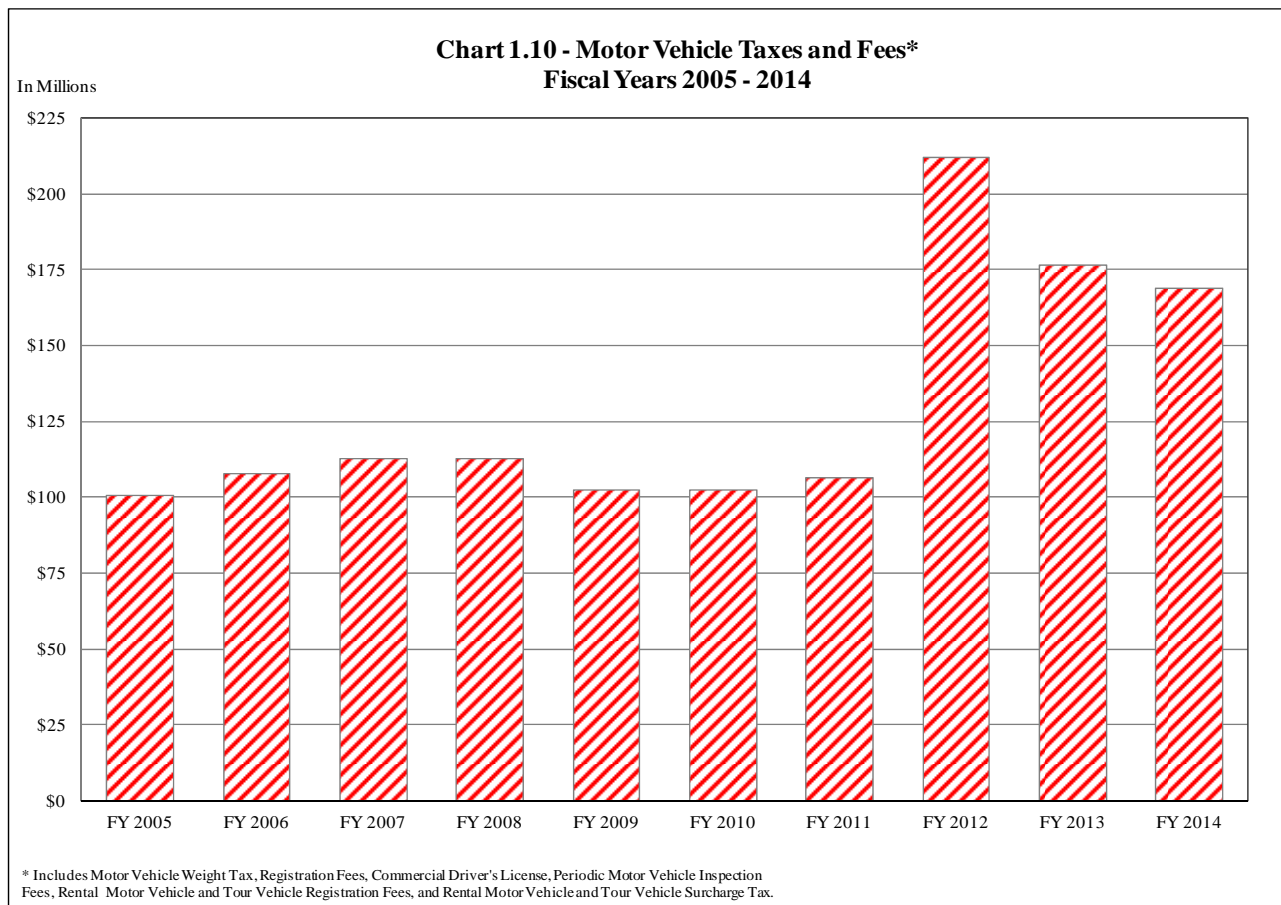
1.7 MOTOR VEHICLE TAXES AND FEES

1.7.1 Overview

The State levies an annual registration fee per vehicle and a tax based on vehicle weight. The State also levies the Rental Motor Vehicle Surcharge (RMVS) tax for motor vehicles that are rented or leased. The tax is imposed on the lessor. The rate of the RMVS tax was \$3.00 per day on and after July 1, 2012. There is also a tour vehicle surcharge tax of \$65 per month for each tour vehicle in the 25 passenger seat and over category and \$15 per month for each tour vehicle in the 8 to 25 passenger seat category. The tax is levied on the tour vehicle operator. There is a one-time \$20 registration fee for those subject to the taxes on rental or tour vehicles.

1.7.2 Revenue

For FY 2014, the State's motor vehicle taxes and fees (including the RMVS) totaled \$168.7 million, compared to \$176.3 million in FY 2013, a decline of 4.3%. Chart 1.10 shows the total motor vehicle taxes and fees for FY's 2005 through 2014. The large increase in FY 2012 was caused by a temporary increase in the rate of the RMVS to \$7.50 per day, which was in place for the period from July 1, 2011 to June 30, 2012. The collections for FY 2013 also reflect one month of collections at the higher tax rate, since the collections lag the liabilities incurred by one month.



1.7.3 Recent Legislation

Act 101, SLH 2014 levies a new car-sharing vehicle surcharge tax of 25 cents per half hour, beginning January 1, 2015.

1.8 CIGARETTE AND TOBACCO TAX

1.8.1 Overview

Wholesalers and dealers, as those terms are defined in section 245-1, HRS, must pay an excise tax on the sale or use of tobacco products and on each cigarette or little cigar sold, used, or possessed. The tax per cigarette or little cigar was increased to 16 cents for sales on and after July 1, 2011. The excise tax on large cigars is 50% of the wholesale price and the excise tax on all other tobacco products (tobacco in any form except cigarettes, little cigars or large cigars) is 70% of the wholesale price. A \$2.50 tobacco tax license is required and must be renewed before July 1 each year. Cigarette wholesalers and dealers are required to affix a stamp to each individual cigarette package as proof that the tax has been paid. Every retailer engaged in the retail sale of cigarettes and other tobacco products is required to obtain a \$20.00 retail tobacco permit that must be renewed before December 1 each year.

1.8.2 Revenue

During FY 2014, collections of the Cigarette and Tobacco Tax (including tobacco licenses) totaled \$121.7 million, compared to \$127.9 million in FY 2013, a decrease of 4.8%. Chart 1.11 shows the total collections of the tax for FY's 2005 through 2014. The 16 cent tax per cigarette was distributed as follows in FY 2014: 2.0 cents per cigarette went to the Hawaii Cancer Research Special Fund, 0.75 cents per cigarette went to the Trauma System Special Fund, 0.75 cents per cigarette went to the Community Health Centers Special Fund, and 0.50 cents went to the Emergency Medical Services Special Fund. The remainder of the Cigarette and Tobacco Tax went to the General Fund. Table 1.7 shows collections of the tobacco taxes and how the revenues were allocated in FY's 2013 and 2014.

**Chart 1.11 - Cigarette and Tobacco Tax & License
Fiscal Years 2005 - 2014**

In Millions



**TABLE 1.7 - CIGARETTE & TOBACCO TAX
(In Thousands of Dollars)**

| | FY 2014 | FY 2013 | Difference | |
|--|-------------------|-------------------|-------------------|--------------|
| | | | Amount | % Change |
| Collection | | | | |
| Tobacco & Licenses | \$ 121,742 | \$ 127,881 | \$ (6,139) | (4.8) |
| Distribution* | | | | |
| Hawaii Cancer Research Fund | \$ 14,058 | \$ 15,777 | \$ (1,719) | (10.9) |
| Trauma System Fund | \$ 10,540 | \$ 5,919 | 4,621 | 78 |
| Emergency Medical Services Fund | 8,787 | 3,938 | 4,850 | 123 |
| Community Health Centers Fund | 8,787 | 5,919 | 2,868 | 48.5 |
| Cigarette Stamp Administrative & Enforcement Funds | 1,911 | 2,148 | (237) | (11.0) |
| General Fund | 77,659 | 94,180 | (16,521) | (17.5) |
| Total | <u>\$ 121,742</u> | <u>\$ 127,881</u> | <u>\$ (6,139)</u> | <u>(4.8)</u> |

*Details on distributions of the revenues are given in section 245-15, HRS.

NOTE: Due to rounding, details may not add to totals.

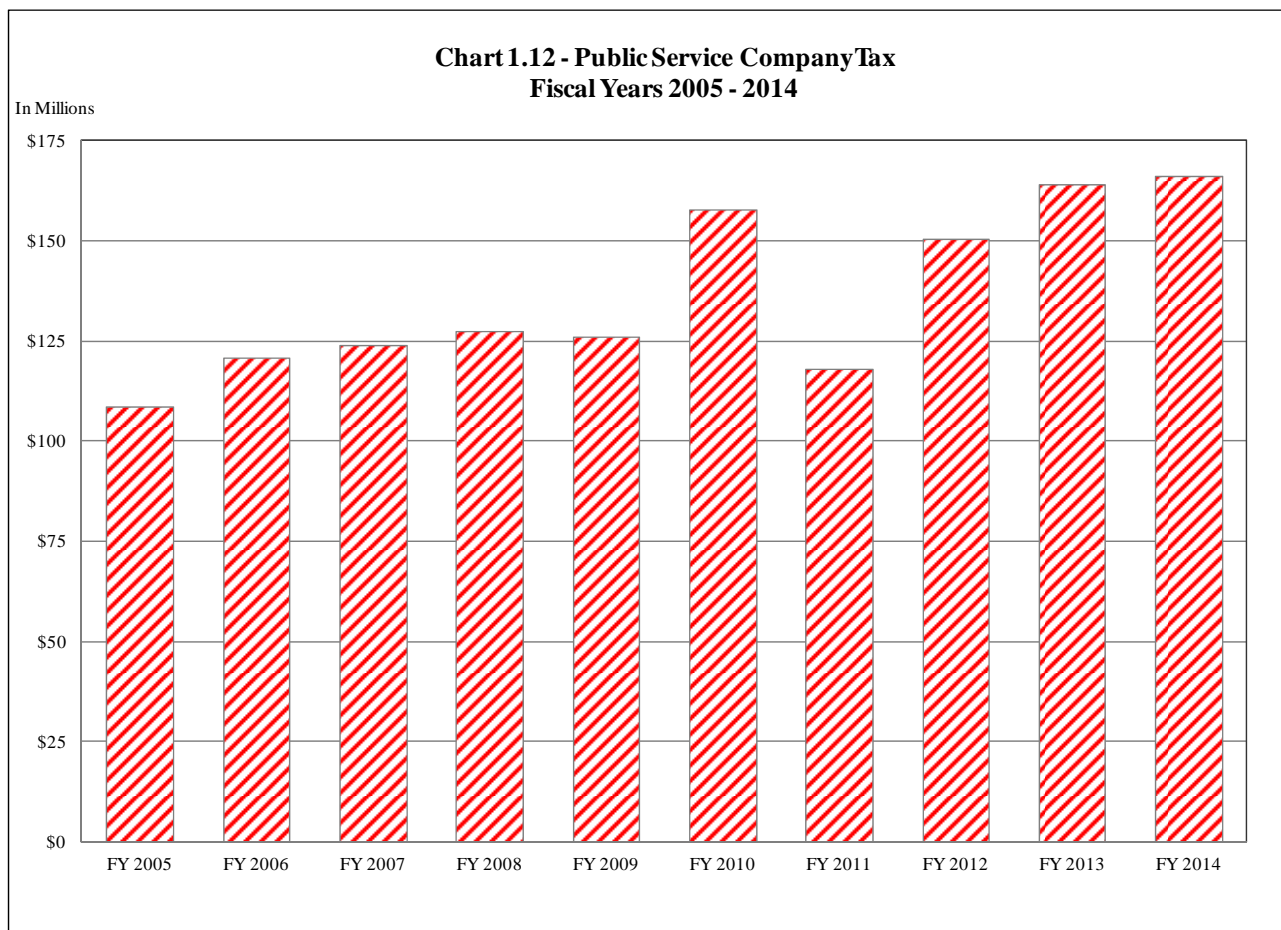
1.9 PUBLIC SERVICE COMPANY TAX

1.9.1 Overview

The Public Service Company (PSC) Tax is levied on public utility businesses in lieu of all taxes except income taxes, vehicular taxes imposed under chapter 249, HRS, the franchise tax on public utilities imposed under chapter 240, HRS, and the Use Tax imposed under chapter 238, HRS. Generally, the tax is applied to gross income from the business of public utilities for the preceding calendar year. The tax rates on the PSC's range from 0.5% (levied on sales for resale) to 8.2%. For a public utility, only the first 4% is realized by the State; any excess over 4% is distributed to counties that provide a real property tax exemption for property used by the public utility in its business. For a carrier of passengers by land between points on a scheduled route, the gross income from passenger fares is taxed at 5.35%, all of which is realized by the State.

1.9.2 Revenue

The PSC Tax yielded \$166.2 million in tax, penalty, and interest in FY 2014, an increase of 1.4% over the \$163.9 million in FY 2013. All of the revenues from the PSC Tax are allocated to the General Fund. Chart 1.12 shows the total collections of the tax for FY's 2005 through 2014.



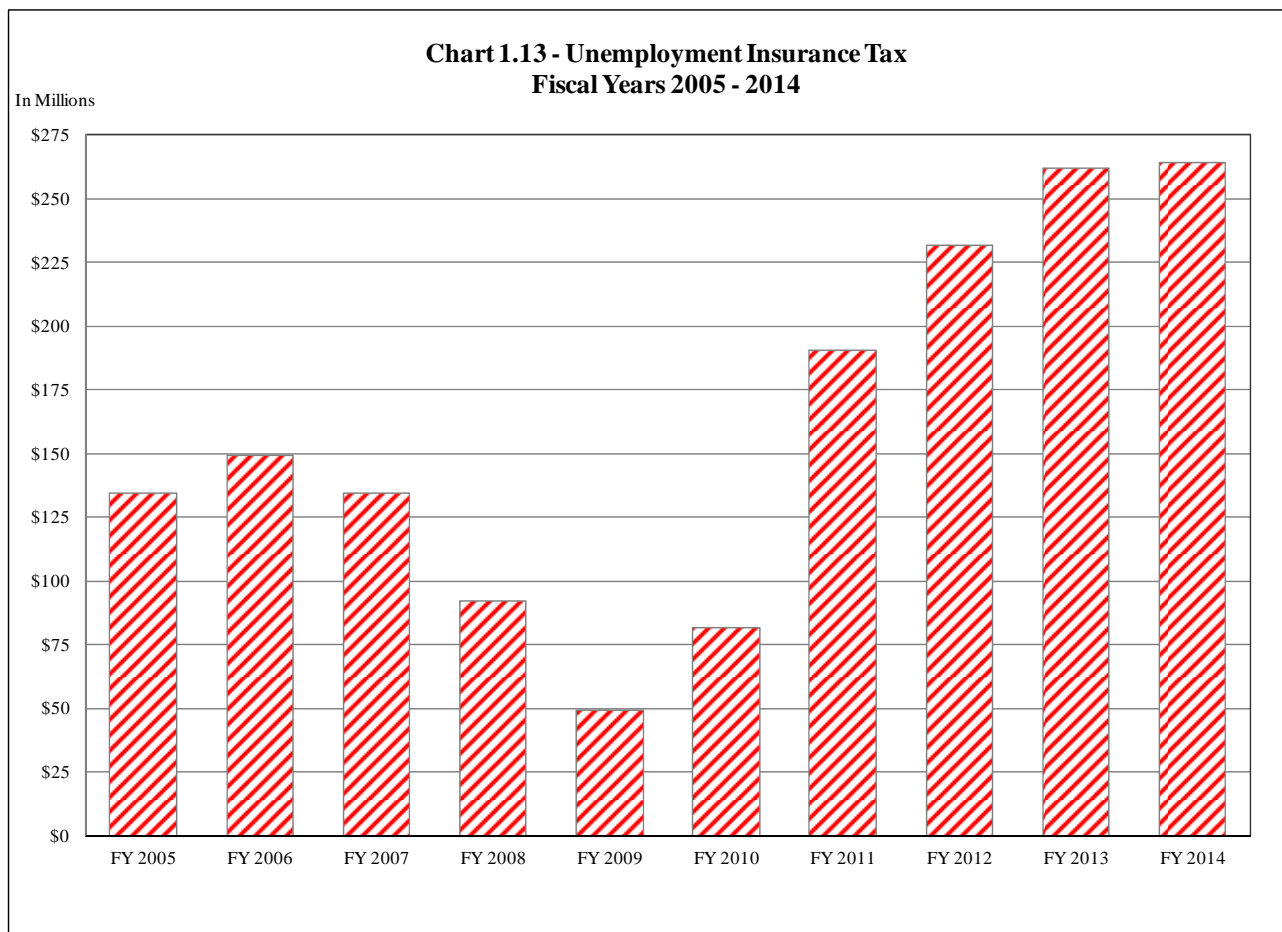
1.10 UNEMPLOYMENT INSURANCE TAX

1.10.1 Overview

The Unemployment Insurance (UI) Tax (officially "Employment Security Contributions") is imposed on wages paid by employers with one or more employees, with certain exemptions. The UI tax rate for each year depends on the condition of the UI Trust Fund. An employer's contribution rate cannot be less than 0.0% or greater than 5.4%. There is also an additional employment and training fund assessment applicable to all employers. The tax is levied on wages paid to an employee, up to a limit called the "tax base." The tax base represents the state's average annual wages reported by employers contributing to the unemployment trust fund. For 2014, the tax base was set at \$40,000. Revenues from the tax go to the Unemployment Security Fund. The Department of Labor and Industrial Relations administers the UI Tax and the Department of Taxation collects the tax.

1.10.2 Revenue

For FY 2014, revenue from the UI Tax totaled \$193.5 million, a slight increase from the \$193.9 million in FY 2013. Chart 1.13 shows collections of the UI Tax for FY's 2005 through 2014.



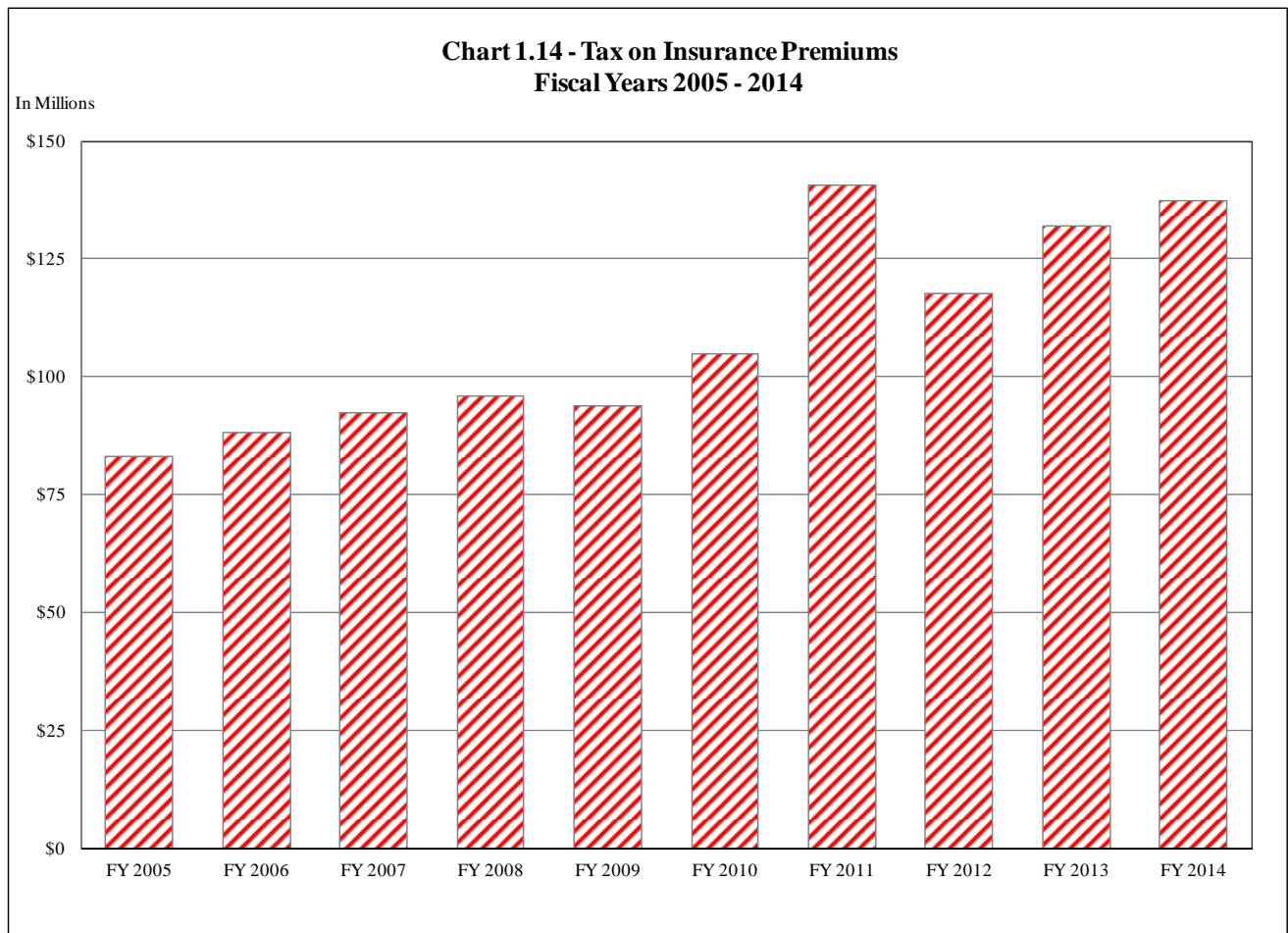
1.11 INSURANCE PREMIUM TAX

1.11.1 Overview

The tax on insurance premiums applies to insurance companies (underwriters) based on premiums written in Hawaii. The insurance premium tax is in lieu of all taxes except property tax and taxes on the purchase, use or ownership of tangible personal property. The tax rates are as follows: (1) Life Insurance, 2.75%; (2) Surplus Lines, 4.68%; (3) Ocean Marine, 0.8775% on gross underwriting profit; and (4) Other Insurance, 4.265%. To insurers who qualify, there is a 1% tax credit to facilitate regulatory oversight. The tax is administered and collected by the Insurance Commissioner, who is required to report to the Director of Taxation the amounts of all taxes collected under chapter 431, HRS.

1.11.2 Revenue

During FY 2014, the tax on insurance premiums totaled \$137.2 million, compared to \$131.9 million in FY 2013, an increase of 4.0%. Chart 1.14 shows collections of the tax for FY's 2005 through 2014.



1.11.3 Recent Legislation

Effective, July 1, 2010, Act 59, SLH 2010, temporarily increases (until July 1, 2014) certain insurance fees and specifies that the increased fees be deposited equally into the Compliance Resolution Fund and the General Fund. All of the insurance fees have been deemed to be non-tax revenues, so they are excluded from the total tax collections and from the General Fund tax revenues.

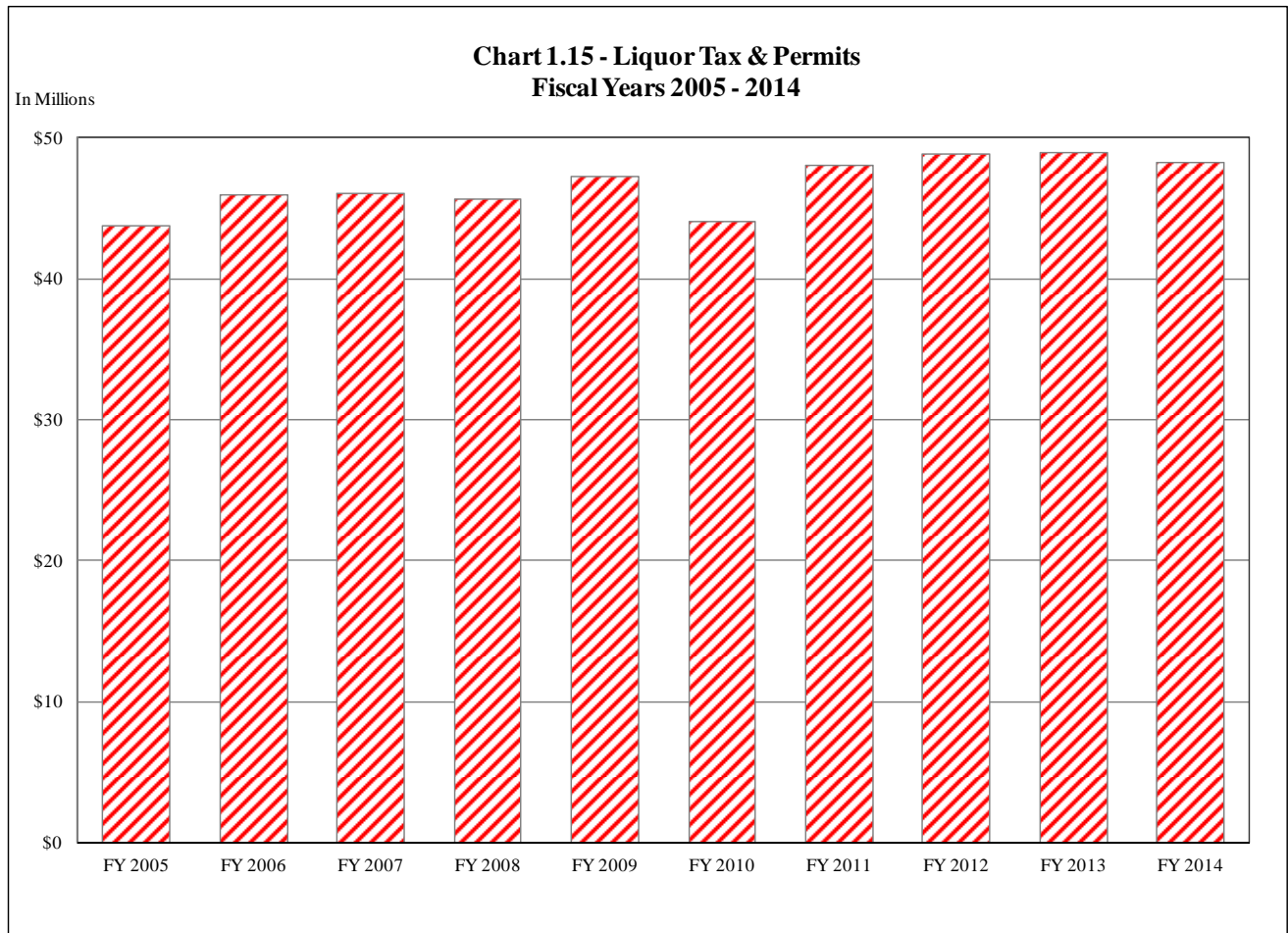
1.12 LIQUOR TAX

1.12.1 Overview

The Liquor Tax is a gallonage tax imposed upon "dealers" as defined in section 244D-1, HRS, and upon certain others who sell or use liquor. A \$2.50 Liquor Tax permit is required and must be renewed before July 1 each year. See section 244D-4, HRS, for exemptions from the tax. The tax rates per wine gallon are \$5.98 on distilled spirits, \$2.12 on sparkling wine, \$1.38 on still wine, \$0.85 on cooler beverages, \$0.93 on beer other than draft beer, and \$0.54 on draft beer.

1.12.2 Revenue

During FY 2013, the Liquor Tax and permit fees totaled \$48.3 million, a small decline from the \$49.0 million collected in FY 2013. Chart 1.15 shows collections of the Liquor Tax and permit fees for FY's 2005 through 2014.



1.13 CONVEYANCE TAX

1.13.1 Overview

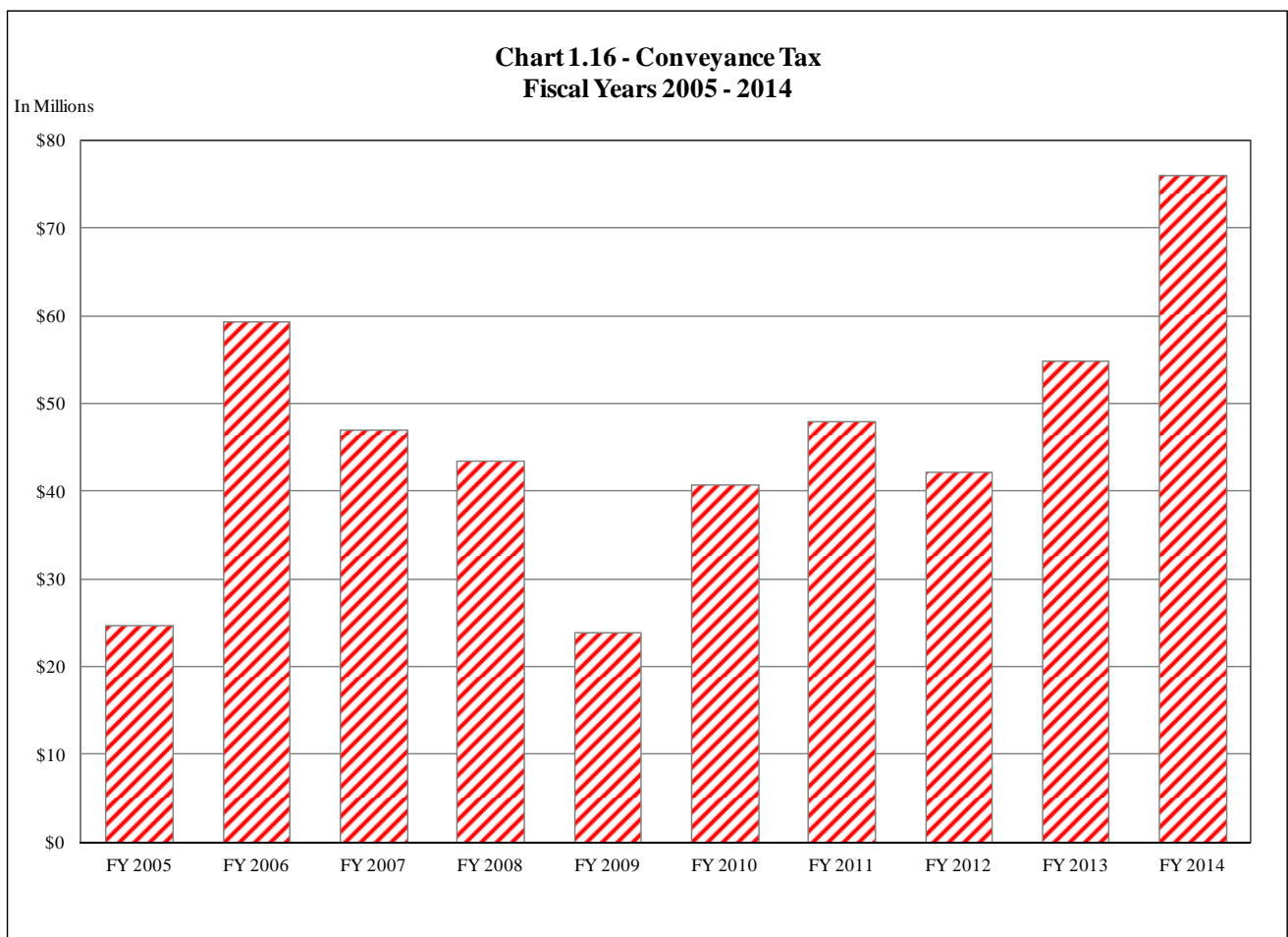
The Conveyance Tax is imposed on all documents transferring ownership or interest in real property and is based on the actual and full consideration paid or to be paid. For a sale of a condominium or single family residence, the rate of the Conveyance Tax depends on whether the purchaser is eligible for a county homeowners' exemption from the real property tax. If the purchaser is eligible for the exemption, or if the sale is of real property other than a condominium or single family residence, then the tax rate ranges from 10 cents per \$100 for properties with a value of less than \$600,000 to \$1 per \$100 for properties with a value of \$10 million or more. If the purchaser is ineligible for the exemption, the tax rate for a sale of a condominium or single family residence ranges from 15 cents per \$100 for properties with a value of less than \$600,000 to \$1.25 per \$100 for properties with a value of \$10,000,000 or more. The Conveyance Tax is administered by the Department of Taxation, but it is collected by the Bureau of Conveyances in the Department of Land and Natural Resources.

1.13.2 Revenue

For FY 2014, revenue from the Conveyance Tax totaled \$75.8 million, compared to \$54.7 million in FY 2013, an increase of 38.6%. The revenues for FY 2014 were distributed as follows: 10% went to the Land Conservation Fund, 30% went to the Rental Housing Trust Fund, 25% went to the Natural Area Reserve Fund and the remaining 35% went to the General Fund. Chart 1.16 shows collections of the Conveyance Tax for FY's 2005 through 2014.

1.13.3 Recent Legislation

Act 163, SLH 2014 increases allocations of the Conveyance Tax to the Rental Housing Trust Fund from 30% to 50% beginning July 1, 2014.



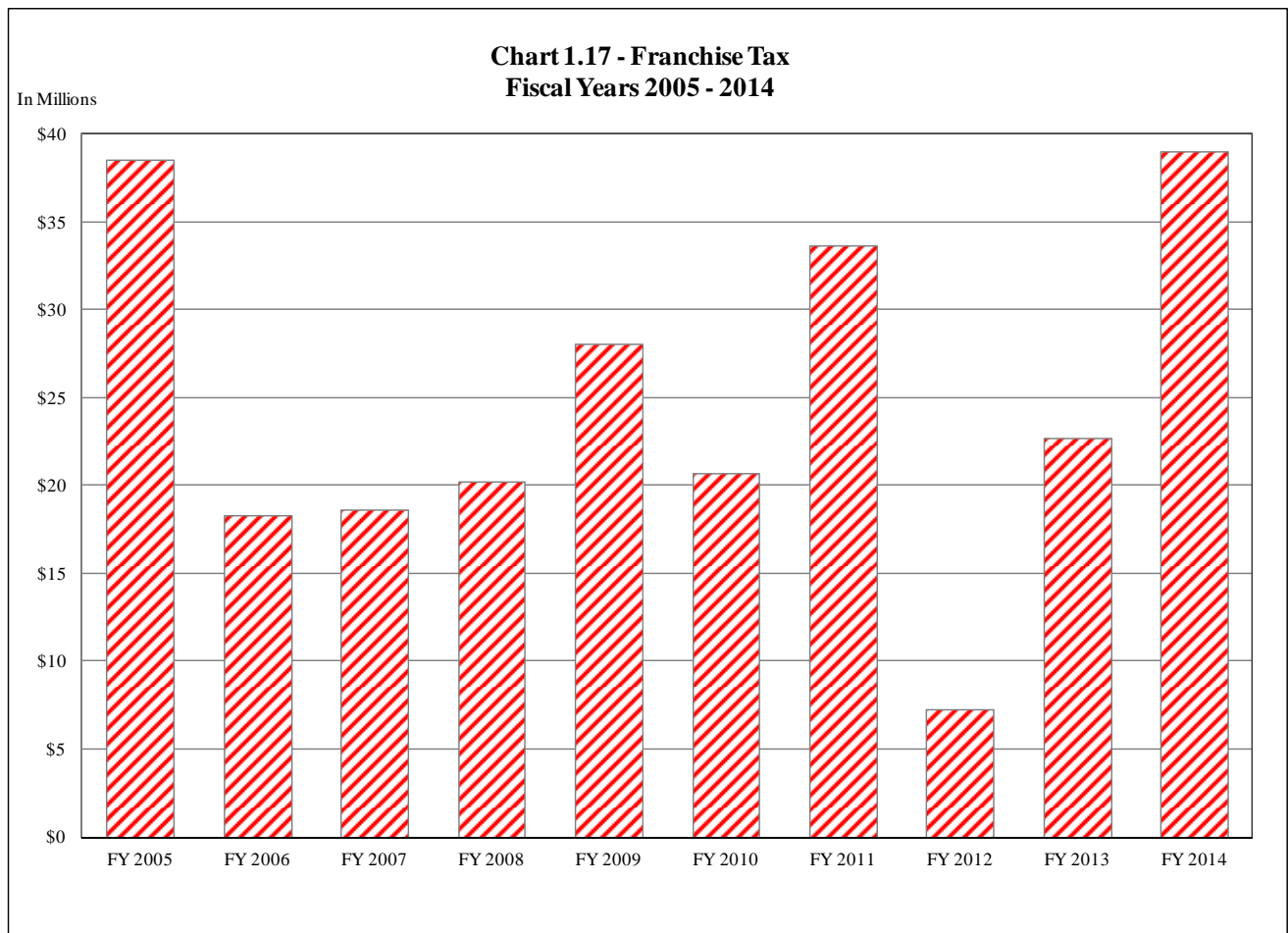
1.14 TAX ON BANKS AND OTHER FINANCIAL CORPORATIONS

1.14.1 Overview

The tax on banks and other financial corporations (the Franchise Tax) is levied on net income of banks, building and loan associations, development companies, financial corporations, financial services loan companies, trust companies, mortgage loan companies, financial holding companies, small business investment companies, and subsidiaries not subject to the tax imposed by chapter 235, HRS. The tax is in lieu of the net income tax imposed under chapter 235, HRS, and of the GET, but it uses the definition of net income from chapter 235, with modifications. The tax is levied on net income at the rate of 7.92%. The assessment date is January 1 of each year.

1.14.1 Revenue

During FY 2014, Franchise Tax collections totaled \$39.0 million, compared to \$22.7 million in FY 2013, an increase of 71.9%. Chart 1.17 shows collections of the Franchise Tax for FY's 2005 through 2014. Collections of the tax were low in FY 2012, due partly to a one-time transfer of \$16.5 million to the Litigated Claims Fund.



1.15 ESTATE AND TRANSFER TAX

1.15.1 Overview

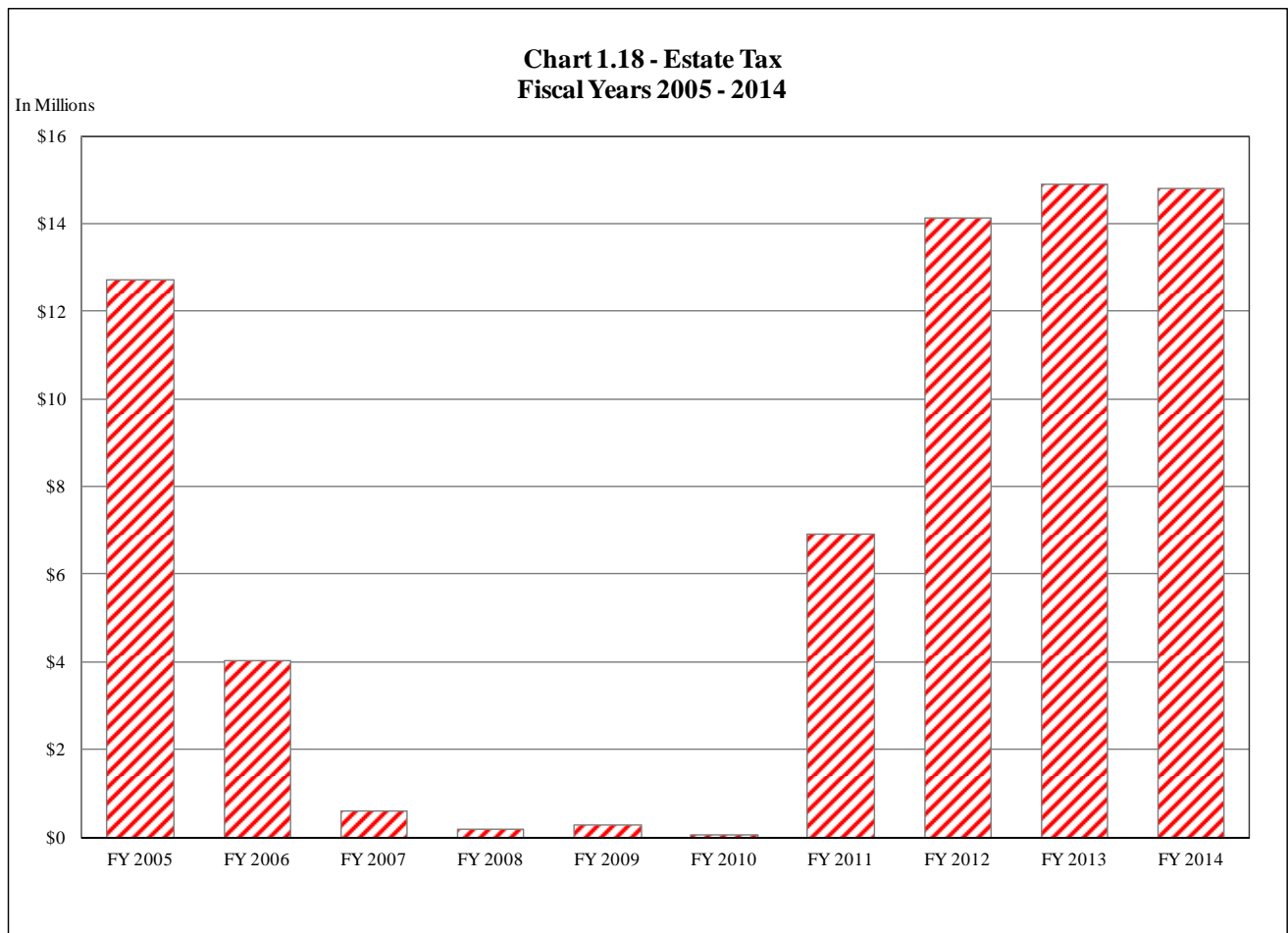
Hawaii's Estate and Transfer Tax is levied on the transfer of a taxable estate. The taxable estate is based on the federal definition (with adjustments for nonresidents), but the State has its own tax rate schedule, with tax rates varying from 10.0% to 15.7%. The generation skipping tax is also based on the federal taxable transfer, but has its own tax rate (currently 2.25%).

1.15.2 Revenue

During FY 2014, estate tax collections totaled \$14.8 million, down very slightly from the \$14.9 million collected in FY 2013. Chart 1.18 shows collections of the Estate and Transfer Tax for FY's 2005 through 2014.

1.15.3 Recent Legislation

Act 44, SLH 2014 conforms Hawaii's estate tax to the Internal Revenue Code and closes a loophole in the tax for decedents dying after December 31, 2013.



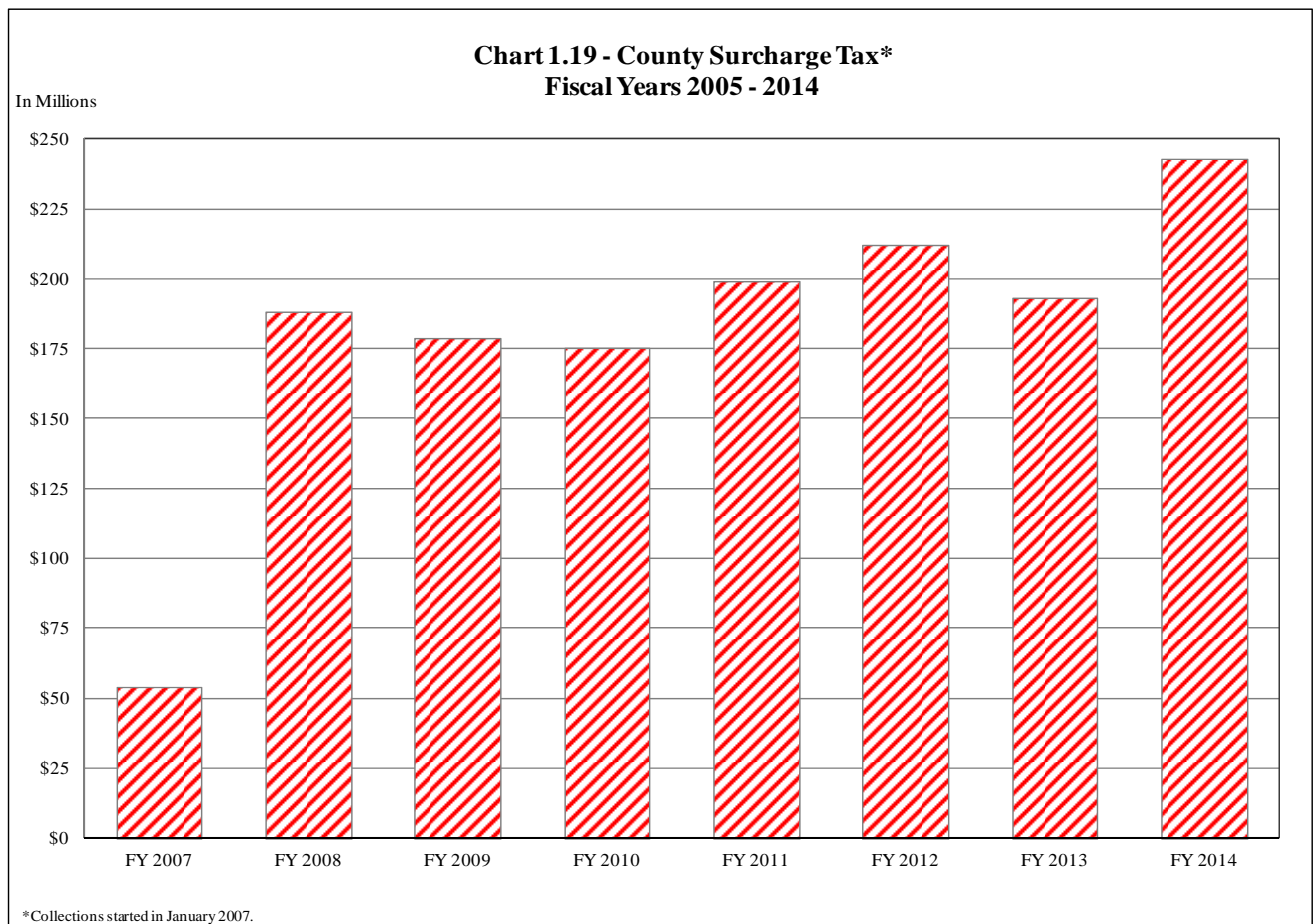
1.16 CITY AND COUNTY OF HONOLULU SURCHARGE TAX

1.16.1 Overview

Act 247, SLH 2005, granted counties the authority to impose a County Surcharge of no more than 0.5% on gross income that is subject to the State's GET at the rate of 4% to fund county public transportation systems. The Act specified that the surcharge be levied no earlier than January 1, 2007 and that it be automatically repealed on December 31, 2022. The Department of Taxation is required to administer and collect the surcharge for the counties. The City and County of Honolulu was the only county to adopt the surcharge, which took effect on January 1, 2007. The State keeps 10% of the collections from the County Surcharge as administrative costs, and Honolulu County receives the remaining 90% of the collections.

1.16.2 Revenue

In FY 2014, collections of Honolulu's County Surcharge totaled \$242.7 million, an increase of 25.7% from the \$193.1 million collected in FY 2012. The reason for the large increase was that processing of the General Excise Tax returns was delayed at the end of FY 2013, which had the effect of moving some County Surcharge collections from FY 2013 into FY 2014. Chart 1.19 shows collections of the County Surcharge for FY's 2005 through 2014.



1.17 TOTAL TAX COLLECTIONS

Total tax collections in FY 2014 amounted to \$6.58 billion, up just slightly from the \$6.54 billion collected in FY 2013. The Department collected the great majority of the total taxes (\$6.24 billion), but the counties collected \$125.9 million in State motor vehicle weight taxes and registration fees, the Insurance Commissioner (in the Department of Commerce and Consumer Affairs) collected \$137.2 million in insurance premium taxes, and the Bureau of Conveyances (in the Department of Land and Natural Resources) collected \$75.8 million in Conveyance Tax. The total collections are shown in Table 1.8.

TABLE 1.8 - TAX COLLECTIONS

(In Thousands of Dollars)

| SOURCE OF REVENUE | FY 2014 | | FY 2013 | |
|-----------------------------------|---------------------|---------------|---------------------|---------------|
| | Amount Collected | % of Total | Amount Collected | % of Total |
| Banks - Financial Corps. | \$ 38,983 | 0.59 | \$ 22,673 | 0.35 |
| Conveyance | 75,831 | 1.15 | 54,686 | 0.84 |
| Employment Security Contributions | 264,178 | 4.01 | 262,290 | 4.01 |
| Fuel | 193,550 | 2.94 | 193,949 | 2.96 |
| General Excise & Use | 2,880,541 | 43.77 | 2,944,487 | 45.01 |
| Honolulu County Surcharge | 242,657 | 3.69 | 193,136 | 2.95 |
| Income - Corporations | 87,021 | 1.32 | 100,988 | 1.54 |
| Income - Individuals | 1,745,810 | 26.53 | 1,736,007 | 26.54 |
| Inheritance and Estate | 14,789 | 0.22 | 14,886 | 0.23 |
| Insurance Premiums | 137,179 | 2.08 | 131,906 | 2.02 |
| Liquor & Permits | 48,305 | 0.73 | 48,962 | 0.75 |
| Motor Vehicle Tax * | 168,726 | 2.56 | 176,295 | 2.70 |
| Public Service Companies | 166,179 | 2.52 | 163,930 | 2.51 |
| Tobacco & Licenses | 121,742 | 1.85 | 127,881 | 1.95 |
| Trans. Accom. Fees | 13 | 0.00 | 20 | 0.00 |
| Trans. Accom. Tax | 395,229 | 6.01 | 368,556 | 5.63 |
| All Others ** | 692 | 0.01 | 648 | 0.01 |
| TOTAL | \$ 6,581,424 | 100.00 | \$ 6,541,300 | 100.00 |

* Includes motor vehicle weight tax, registration fees, commercial driver's license, periodic motor vehicle inspection fees, rental motor vehicle and tour vehicle registration fees, and rental motor vehicle and tour vehicle surcharge tax.

** Includes fuel retail dealer permits, fuel penalty and interest, permitted transfers tax, and general excise fees.

NOTE: Due to rounding, details may not add to totals.

1.18 DISTRIBUTION OF TAXES

Of the \$6.58 billion in total tax collections in FY 2014, \$5.37 billion or 81.6% was deposited into the State's General Fund. The four counties received \$167.0 million or 2.5% of the tax collections, which came from county fuel taxes and the TAT. In addition, \$242.7 million of County Surcharge was collected for the City and County of Honolulu (before deducting the 10% administrative fee imposed by the State). The remaining tax revenues not deposited into the General Fund or

transferred to the counties were distributed among several State special funds. The State Highway Fund received the largest portion, \$255.8 million. All of the Unemployment Insurance Tax (the Employment Security Contributions) went into the Unemployment Trust Fund for unemployment benefits. Portions of the TAT went to the next two largest special funds: \$82.0 million went to the Tourism Special Fund and \$33.0 million went to the Convention Center Fund.

Table 1.9 shows allocations of taxes to the State's General Fund in FY's 2013 and 2014. The distributions of the total tax collections among all funds in FY's 2013 and 2014 are shown in Table 1.10.

TABLE 1.9 - STATE GENERAL FUND
(In Thousands of Dollars)

| SOURCE OF REVENUE | FY 2014 | | FY 2013 | |
|--------------------------|---------------------|---------------|---------------------|---------------|
| | Amount Collected | % of Total | Amount Collected | % of Total |
| Banks - Financial Corps. | \$ 36,983 | 0.69 | \$ 20,673 | 0.38 |
| Conveyance | 26,508 | 0.49 | 19,132 | 0.35 |
| General Excise & Use | 2,825,041 | 52.61 | 2,944,487 | 53.86 |
| Income - Corporations | 87,021 | 1.62 | 100,988 | 1.85 |
| Income - Individuals | 1,745,312 | 32.50 | 1,735,499 | 31.75 |
| Inheritance and Estate | 14,789 | 0.28 | 14,886 | 0.27 |
| Insurance Premiums | 137,179 | 2.55 | 131,906 | 2.41 |
| Liquor & Permits | 48,305 | 0.90 | 48,962 | 0.90 |
| Public Service Companies | 166,179 | 3.09 | 163,930 | 3.00 |
| Tobacco & Licenses | 77,659 | 1.45 | 94,180 | 1.72 |
| Trans. Accom. Tax | 187,229 | 3.49 | 171,556 | 3.14 |
| Environmental Tax | 17,356 | 0.32 | 15,537 | 0.28 |
| Rental Vehicle Tax | - | 0.00 | 4,516 | 0.08 |
| All Others * | 707 | 0.01 | 672 | 0.01 |
| TOTAL | \$ 5,370,268 | 100.00 | \$ 5,466,923 | 100.00 |

* Includes fuel retail dealer permits, fuel penalty and interest, permitted transfers tax, general excise fees, trans accom fees and rental vehicle tax

NOTE: Due to rounding, details may not add to totals.

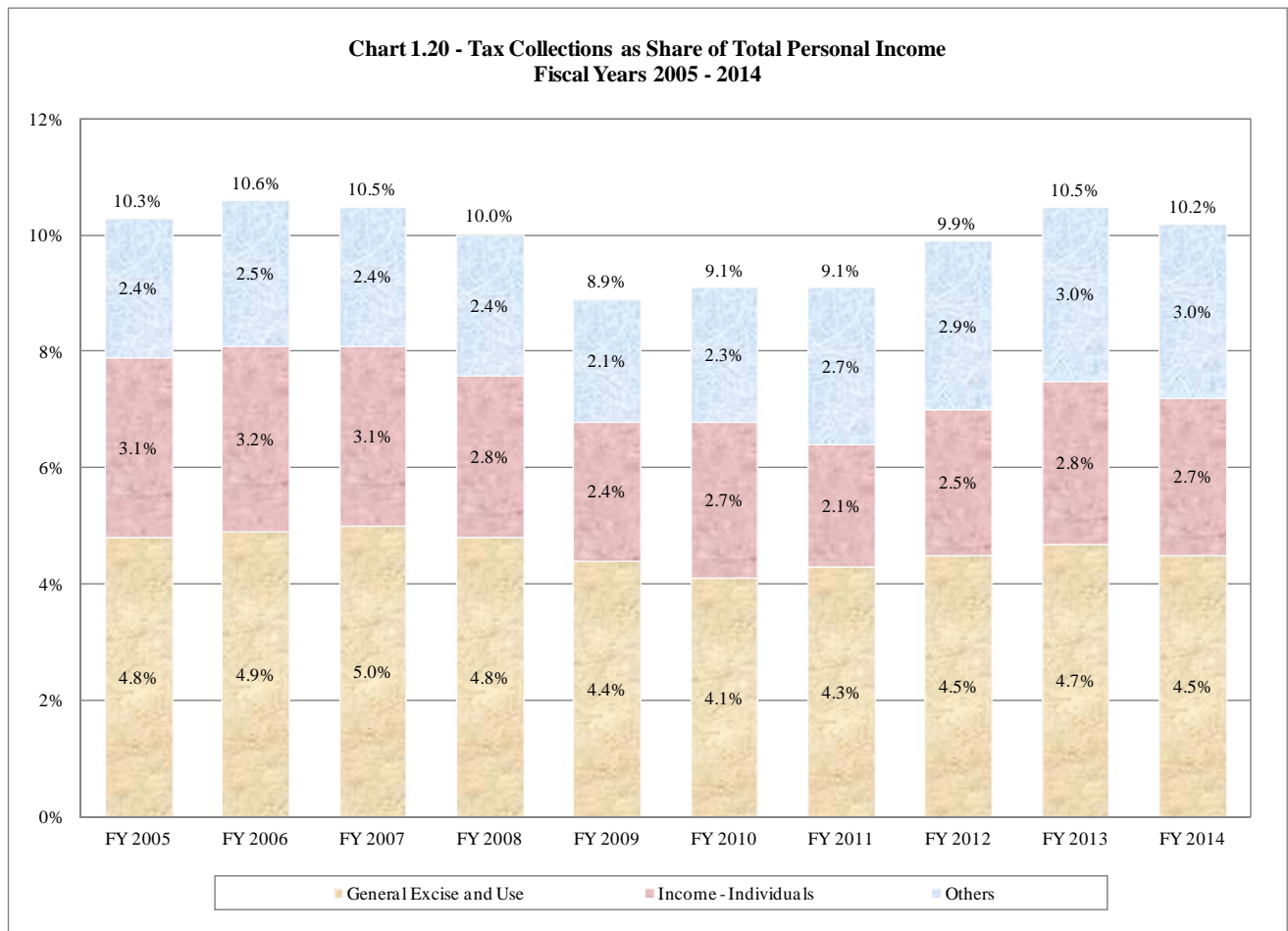
TABLE 1.10 - DISTRIBUTION OF COLLECTIONS
(In Thousands of Dollars)

| | FY 2014 | | FY 2013 | |
|---|-----------------------|---------------|-----------------------|---------------|
| | Amount Distributed | % of Total | Amount Distributed | % of Total |
| <u>STATE FUND</u> | | | | |
| State General | \$ 5,370,268 | 81.60 | \$ 5,466,923 | 83.58 |
| State Highway | 255,805 | 3.89 | 257,801 | 3.94 |
| State Airport | 4,809 | 0.07 | 4,707 | 0.07 |
| Boating Special Fund | 1,627 | 0.02 | 1,621 | 0.02 |
| Environmental Fund | 1,240 | 0.02 | 1,295 | 0.02 |
| Cigarette Stamp Admin/Enf. Fund | 1,911 | 0.03 | 2,148 | 0.03 |
| Compliance Resolution Fund | 2,000 | 0.03 | 2,000 | 0.03 |
| Unemployment Trust Fund | 264,178 | 4.01 | 262,290 | 4.01 |
| Election Campaign Fund | 190.19 | 0.00 | 219 | 0.00 |
| Tourism Special Fund | 82,000 | 1.25 | 71,000 | 1.09 |
| Rental Housing Fund | 22,765 | 0.35 | 16,409 | 0.25 |
| Natural Area Reserve Fund | 18,970 | 0.29 | 13,675 | 0.21 |
| Convention Center Fund | 33,000 | 0.50 | 33,000 | 0.50 |
| Public Libraries Fund | 72 | 0.00 | 68 | 0.00 |
| School Repairs & Maintenance Fund | 77 | 0.00 | 74 | 0.00 |
| Land Conservation Fund | 7,588 | 0.12 | 5,470 | 0.08 |
| Domestic Violence/Child Abuse Neglect Fund | 158 | 0.00 | 147 | 0.00 |
| Cancer Research Fund | 14,058 | 0.21 | 15,777 | 0.24 |
| Trauma System Fund | 10,540 | 0.16 | 5,919 | 0.09 |
| Emergency Medical Service Fund | 8,787 | 0.13 | 3,938 | 0.06 |
| Community Health Centers Fund | 8,787 | 0.13 | 5,919 | 0.09 |
| Energy Security Fund | 3,719 | 0.06 | 3,884 | 0.06 |
| Energy Systems Development Fund | - | - | 2,590 | 0.04 |
| Agricultural Development & Food Security Fund | 3,719 | 0.06 | 3,884 | 0.06 |
| Hurricane Relief Fund | 55,500 | 0.84 | - | - |
| Subtotal - State | \$ 6,171,769 | 93.78 | \$ 6,180,758 | 94.49 |
| <u>HONOLULU COUNTY SURCHARGE</u> | \$ 242,657 | 3.69 | \$ 193,136 | 2.95 |
| <u>REVENUES TRANSFERRED TO COUNTIES</u> | | | | |
| Other County Revenues | | | | |
| Fuel Tax | \$ 73,999 | 1.12 | \$ 74,407 | 1.14 |
| Trans. Accom. Tax | 93,000 | 1.41 | 93,000 | 1.42 |
| Subtotal - Counties | \$ 166,999 | 2.54 | \$ 167,407 | 2.56 |
| TOTAL | \$ 6,581,424 | 100.00 | \$ 6,541,300 | 100.00 |

NOTE: Due to rounding, details may not add to totals.

1.19 TRENDS IN TAX COLLECTIONS

Table 1.11 provides data on total tax collections for FY's 2005 through 2014. Chart 1.20 shows total tax collections relative to total personal income (TPI) in the State for FY's 2005 through 2014.² From FY 2005 to FY 2006, the ratio of tax collections to TPI increased, but from FY 2006 to FY 2009, the ratio declined, with big declines in collections of both the GET and the IIT relative to TPI. The ratio grew each year from FY 2009 to FY 2013, but fell from FY 2013 to FY 2014.



² The chart uses the most recent figures from the Bureau of Economic Analysis (BEA) for TPI. The Bureau periodically updates TPI figures and the updates often extend back for a number of years.

TABLE 1.11 - HISTORICAL COLLECTIONS FOR SELECTED TAXES
(In Thousands of Dollars)

| SOURCE OF REVENUE | Fiscal Year | | | | |
|------------------------------|-------------|-------------|-------------|-------------|-------------|
| | 2005 | 2006 | 2007 | 2008 | 2009 |
| General Excise and Use | \$2,136,603 | \$2,355,316 | \$2,555,762 | \$2,618,787 | \$2,417,580 |
| Income - Individuals | 1,381,480 | 1,550,596 | 1,560,286 | 1,544,835 | 1,339,056 |
| Transient Accom. Tax & Fees | 198,784 | 217,008 | 224,942 | 229,388 | 210,622 |
| Unemployment Insurance | 134,459 | 149,388 | 134,612 | 92,279 | 49,071 |
| Motor Vehicle Tax 1/ | 100,278 | 107,527 | 112,412 | 112,448 | 101,991 |
| Fuel | 162,873 | 166,138 | 169,712 | 169,927 | 165,717 |
| Public Service Companies | 108,686 | 120,679 | 124,017 | 127,481 | 126,069 |
| Tobacco and Licenses | 85,245 | 88,261 | 94,387 | 104,624 | 108,164 |
| Insurance Premiums 2/ | 83,077 | 88,068 | 92,196 | 95,742 | 93,720 |
| Income - Corporations | 85,605 | 130,010 | 81,834 | 85,081 | 53,522 |
| Liquor and Permits | 43,737 | 45,955 | 46,034 | 45,620 | 47,242 |
| Conveyance | 24,583 | 59,201 | 46,887 | 43,421 | 23,772 |
| Banks-Financial Corporations | 38,520 | 18,324 | 18,599 | 20,212 | 28,075 |
| Total Collections 3/ | \$4,597,415 | \$5,101,011 | \$5,316,593 | \$5,478,491 | \$4,944,133 |

| SOURCE OF REVENUE | Fiscal Year | | | | |
|------------------------------|-------------|-------------|-------------|-------------|-------------|
| | 2010 | 2011 | 2012 | 2013 | 2014 |
| General Excise and Use | \$2,316,434 | \$2,495,807 | \$2,697,951 | \$2,944,487 | \$2,880,541 |
| Income - Individuals | 1,528,110 | 1,247,153 | 1,541,051 | 1,736,007 | 1,745,810 |
| Transient Accom. Tax & Fees | 224,252 | 284,472 | 323,951 | 368,576 | 395,242 |
| Unemployment Insurance | 82,017 | 190,511 | 231,669 | 262,290 | 264,178 |
| Motor Vehicle Tax 1/ | 102,319 | 106,166 | 211,742 | 176,295 | 168,726 |
| Fuel | 155,703 | 195,336 | 193,101 | 193,949 | 193,550 |
| Public Service Companies | 157,661 | 117,940 | 150,528 | 163,930 | 166,179 |
| Tobacco and Licenses | 123,489 | 143,293 | 138,798 | 127,881 | 121,742 |
| Insurance Premiums 2/ | 104,721 | 140,456 | 117,617 | 131,906 | 137,179 |
| Income - Corporations | 59,186 | 34,573 | 73,026 | 100,988 | 87,021 |
| Liquor and Permits | 44,074 | 48,054 | 48,854 | 48,962 | 48,305 |
| Conveyance | 40,634 | 47,906 | 42,106 | 54,686 | 75,831 |
| Banks-Financial Corporations | 20,666 | 33,677 | 7,229 | 22,673 | 38,983 |
| Total Collections 3/ | \$5,134,807 | \$5,292,193 | \$6,004,268 | \$6,541,300 | \$6,581,424 |

1/ Includes State Motor Vehicle Weight Tax, Registration Fees, Commercial Driver's License, Periodic Motor Vehicle Inspection Fees, Rental Vehicle Registration Fees and Rental Vehicle Surcharge Tax.

2/ Excludes Insurance Fees allocated to the General Fund, which were included in previous reports.

3/ Includes the Inheritance and Estate Tax, the Honolulu County Surcharge, fuel permits, interest and penalties on fuel taxes, general excise fees, and permitted transfers tax.

2.0 TAX ADMINISTRATION

2.1 OVERALL PERFORMANCE

The Department of Taxation consists of two divisions, four staff offices, a public information officer, and a taxpayer advocate. The two divisions are the Tax Services and Processing Division and Compliance Division. The four staff offices are the Administrative Services Office, the Rules Office, the Tax Research and Planning Office, and the Information Technology Services Office. In addition, there is a System Administration section.

The total number of authorized permanent positions in the Department decreased from 383 positions in FY 2013 to 382 positions in FY 2014. The Department's operating budget is a small fraction of total tax revenue. In FY 2014, the Department's operating expenses were \$20.9 million, down from \$25.5 million in FY 2009. The Department collected \$6.24 billion in taxes in FY 2014, so the cost of collecting each \$100 dollars of taxes was about 33 cents.

The Department has continued to encourage taxpayers to use electronic transmissions rather than filing paper returns. Although there has been a significant increase in electronic filing of tax returns and payments, over 1 million paper checks and over 2 million paper tax returns and other documents were manually processed by the Department in FY 2014.

The total number of audit cases completed by the Compliance Division (the Office Audit Branch and Field Audit Branch combined) rose from 7,701 cases in FY 2013 to 9,202 cases in FY 2014, an increase of 19.5%. Total assessments increased by 13.7%, from \$87.1 million in FY 2013 to \$99.0 million in FY 2014. The Criminal Investigation section collected a total of \$1.3 million in unpaid taxes, interest and penalties in FY 2014, up from the \$1.0 million collected in FY 2013.

2.2 TAX SERVICES AND PROCESSING DIVISION

2.2.1 Overview

The Tax Services and Processing (TSP) Division consists of the following three branches: (1) The Document Processing Branch (DPB), which does centralized processing, editing, and controlling of tax information received from paper documents or electronic data, and receives, secures, deposits, and accounts for tax payments; (2) the Taxpayer Services Branch (TPS), which performs functions relating to account management, licensing, and providing taxpayer services to the public; and (3) the Revenue Accounting Branch (RA), which maintains revenue control and reconciliation functions for all State tax revenues collected by the Department of Taxation, including the preparation of the Preliminary Report (which shows revenues collected), the Statement of Tax Operations (STO, which shows revenues collected and allocations of the revenues to various funds), and other revenue-related reports.

The TSP Division's main goal for the upcoming years is to allow taxpayers to choose from a broader array of options for filing their state tax returns and other documents with the Department. Also, the Division aims to increase reliance on electronic filings and financial transactions. Greater use of electronic transactions will allow data to be processed more efficiently and more effectively with fewer staff. With the Department's Tax System Modernization (TSM) Project

coming in the near future, the TSP Division looks forward to using new technology to provide greater efficiency in processing, stronger accountability in reporting, and higher levels of customer service for the public.

In accordance with the Department's Strategic Plan, the TSP Division strongly supports programs to improve the efficiency, effectiveness, and accountability of its three branches. The TSP Division has taken the following steps to improve processes and enhance productivity and will continue these efforts in FY 2015:

Business Process Reengineering (BPR) Concept

After attending the BPR training held late last year, the TSP attendees met once a week for several weeks to work on our Business Process Reengineering Project to identify processes that could be improved, to indicate how proposed changes would affect the system, and to make recommendations or find possible solutions through the TSM project. The goal is to ensure that the TSM project will improve the efficiency and effectiveness of our operations.

"Lean Program" to Transform Operations

The Lean Program provides guidelines for improving operational processes to increase efficiency and effectiveness, for empowering employees, for focusing on the customer, and for promoting continuous improvements. Based on the guidelines, we have started to assess the backlogs in the various areas of TSP to determine whether or not each step in the process adds value to the end product, to empower employees to make decisions based on established guidelines, to focus on the customers' wants and needs, and to ask for feedback from the staff for continuous process improvement. Some changes have been implemented and positive results were achieved. We will continue such work in the near future.

Office of Information Management Technology (OIMT) Summer Intern Project – July 2013

Three college students in the OIMT Summer Internship Program were assigned to the Department and charged with analyzing the TPS Call Center activities and developing a plan of action to improve operations. Using the "Strengths, Weaknesses, Opportunities and Threats (SWOT) analysis, the interns queried the supervisors and staff to determine what was working effectively, where there was a lack of organizational structure or policy, what improvements could be made, and the possible consequences of any inherent problems.

The interns showed a keen understanding of the situation in the Call Center and made the six recommendations for improvement shown below, some of which have already been implemented.

- Extend the training period for 89-day tax season hires to give them a minimum of 4 to 6 months of training and work experience, so they are better prepared for the upcoming tax season. (Various factors need to be considered in implementing this recommendation, including the budget.)
- Emphasize the immediate and urgent need for new computers and upgraded servers, as server lag-time has posed problems in servicing customers. (New and upgraded

computers and servers have been installed in all areas of TSP in preparation for the TSM Project.)

- Redesign the Department's web page to provide a more user-friendly website and to provide interactive methods of instruction. This would help reduce the number of calls being received. (Some changes have been made to our web page, based on employee and public feedback, with more to come in the future.)
- Create a fluid communication system with customers (i.e., an on-line chat system). (Discussions on this recommendation will be held with the Administration, the Information Technology Services Office, and TSP. Various factors need to be considered, such as cyber security and staffing resources.)
- Raise the wage cap on paraprofessional staff to retain experienced staff in TPS (TSP management is currently working with the Personnel Office and the Department of Human Resources and Development to create higher level positions in TPS.)
- Develop a Mail Processing Tracking System by equipping the Department with a scanning mechanism at the point of entry (mailroom) to acknowledge immediate receipt of tax returns, payments and other documents by the Department. (This recommendation will be considered in the future when the TSM project is implemented.)

TSP Division's next three-year plan is to continue to reengineer key business processes within the Division and to strive to accomplish the following goals by the end of fiscal year 2017:

- Increase voluntary compliance (TPS) – We will increase voluntary compliance by establishing proactive avenues to provide information to taxpayers, by implementing programs that change how taxpayers interact with us, and by training staff to provide information and support to users.
- Modernize tax processing (DPB, TPS, RA) – We will modernize tax processing by doing the following things: Providing a greater number of options for taxpayers to file their State tax returns (DPB); encouraging greater reliance on electronic financial transactions (DPB); providing various avenues for taxpayers to access their own online and real-time account information to acquire tax clearances or to perform online maintenance functions (TPS); and ensuring that all tax system processing at the tax account module level will be fully integrated with the revenue accounting module level so that we have an automated Accounting System of Record that is GAAP and GASB compliant (RA).
- Foster quality-driven productivity (DPB, TPS, RA) – We will foster quality-driven productivity by doing the following things: DPB will establish goals for processing and cashiering remittances, and for uploading remittances, returns, and Basic Business Applications (Form BB-1) into the system from all incoming venues; TPS will post worklisted returns and payments into the system and enable staff to

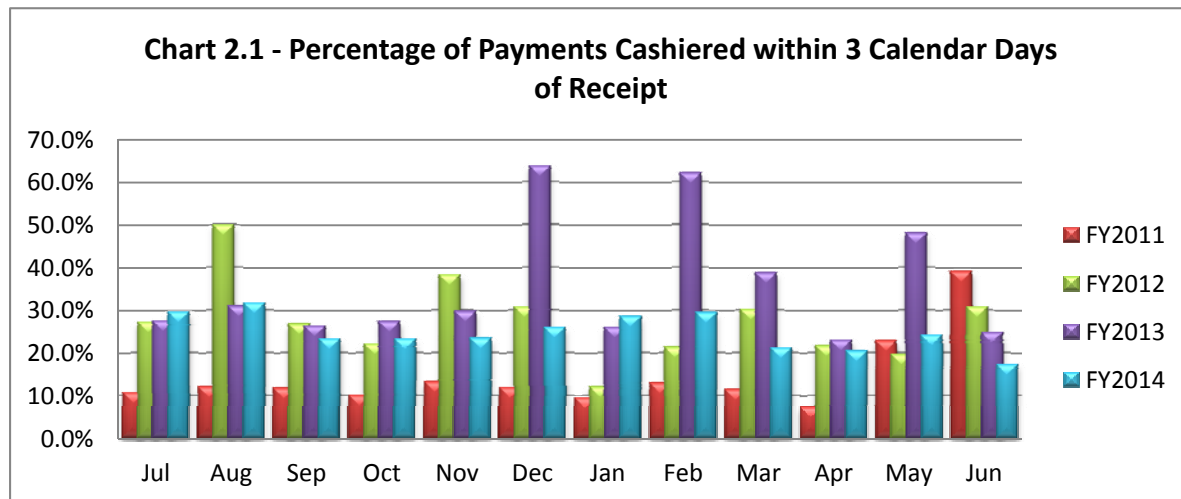
address electronic filing-related inquiries at the first point of contact or support changes in workflow processes; RA will prepare the Monthly Preliminary Report by the 5th working day of each month and the Statement of Tax Operations (STO) and Segregation of Miscellaneous Taxes by the 10th working day of each month,

and enable RA Branch employees to support financial reports issued in accordance with GAAP or GASB requirements.

2.2.2 Document Processing Branch

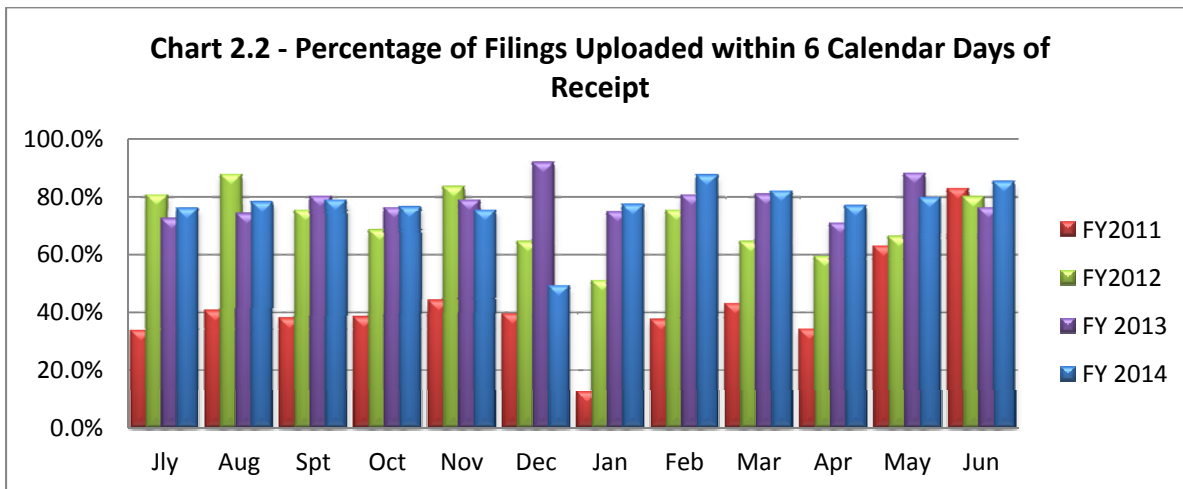
The main function of the DPB is to quickly and efficiently process all tax returns and documents; to receive, secure, deposit, and account for tax payments; to ensure proper storage and retrieval of documents; and to perform various functions relating to electronic filing. The DPB has the following six sections: Receiving and Sorting, Data Preparation, Imaging and Data Entry, Monetary Control, File Maintenance, and Electronic Processing.

For FY 2014, a total of 4,037,655 documents were processed, of which 2,347,541 (58%) were paper and 1,690,114 (42%) were in electronic form. The documents processed included 1,797,256 paper tax returns and 977,261 electronic tax returns. In addition, 1,955,314 payments totaling over \$6.55 billion were received and processed, of which 717,271 payments totaling nearly \$4.8 billion came through electronic channels. In FY 2013, 1,857,422 payments totaling \$6.37 billion were processed, which was nearly \$180 million less than in FY 2014. Although there has been a significant increase in electronic filing of tax returns and payments, over 1 million paper checks and over 2 million paper tax returns and other documents were manually processed by the DPB in FY 2014. Charts 2.1 and 2.2 provide data on the operations of DPB for FY's 2011 to FY 2014.



FY: Average Monthly Percentage of Payments Cashiered Within 3 Days of Receipt

2014 – 24.8%
2013 – 35.7%
2012 – 27.5%
2011 – 14.4%



FY: Average Monthly Filings Uploaded Within 6 Days of Receipt

2014 - 77.0%

2013 - 78.9%

2012 - 71.5%

2011- 42.4%

2.2.3 Revenue Accounting Branch

The main function of the Revenue Accounting Branch (RA) is to maintain accounting records for all tax revenues, refunds (including cashier refunds) and adjustments, district transfers and closing adjustments, and other adjustments, and to prepare all Journal Vouchers and Summary Warrant Vouchers. RA controls, and is responsible for, all adjustment, error resolution, accounting, and reconciliation functions for all tax revenues collected by the Department. Specific tasks include preparing the Preliminary Report, the Statement of Tax Operations (STO), the Daily Cash Collection Report (Oahu District), and the Monthly Segregation of Taxes Reports for Miscellaneous Taxes.

The Preliminary Report is a monthly, statewide summary of all revenues received by the Department, less the amount of tax refunds, which is prepared by the fifth working day of each month. The STO is a formal, detailed report of State revenues that is based on the Preliminary Report and is prepared by the tenth working day of each month. RA has consistently and diligently met the critical deadlines for these reports throughout this fiscal year, as well as in past years.

RA also performs manual accounting activities for all miscellaneous tax collections except the estate and transfer tax; controls and accounts for all State tax refunds resulting from either overpayments or adjustments; maintains the statewide accounting records and prepares journal entries associated with the various administratively-established trust accounts and for other mandated purposes; maintains the manual accounting system for all protested payments and tax appeals; provides allocation reports (in addition to the STO) to the Department of Accounting and General Services and the Department of Budget and Finance; and handles all State refund exception activities, such as returned checks, tracers, or forgeries.

In line with the rest of the TSP Division and as a result of brainstorming sessions, SWOT analyses, and Process Mapping Sessions, RA also made significant improvements in their operations. More specifically, they improved the accuracy of the Statement of Tax Operations and streamlined the reporting to provide more useful and comprehensible reports. This exercise proved to be a good learning experience for the RA team, and should help the branch with the TSM project.

2.2.4 Taxpayer Services Branch

Account Management Section

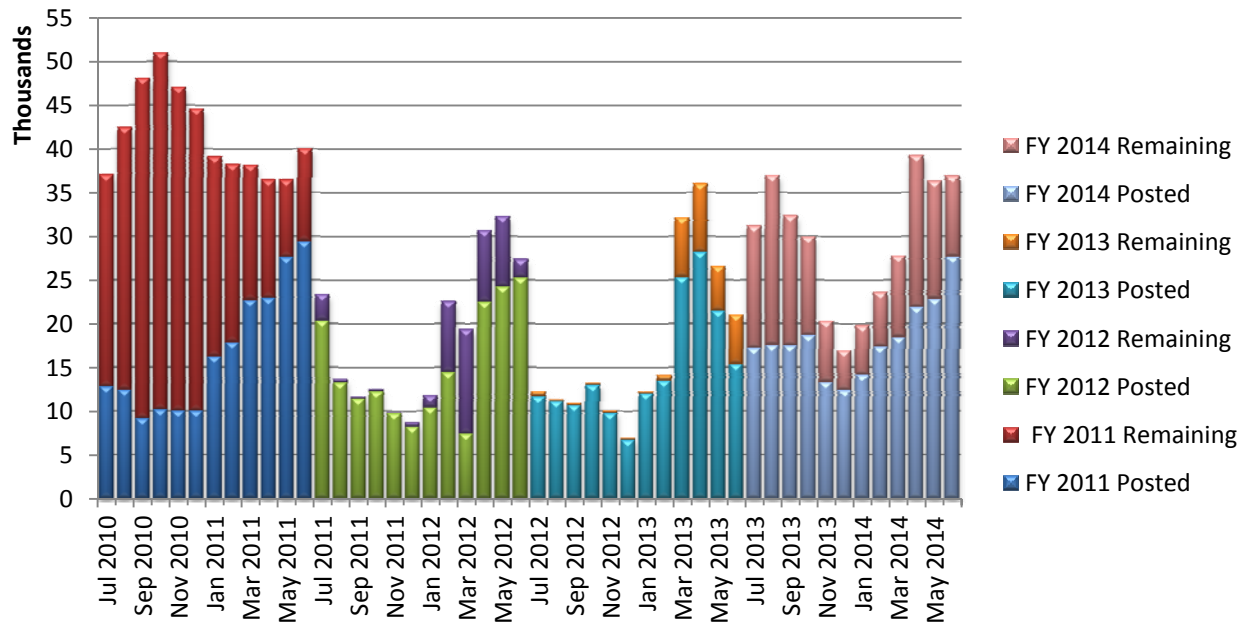
The primary function of Account Management (AM) is to review, analyze and correct errors or other inconsistencies on tax returns and other documents that were identified by our computer system during processing and placed on an electronic worklist for manual review. In FY 2014, the team posted 218,667 returns, payments and other documents from the worklist. The team is highly efficient and also managed to clear most of the refund returns off the worklist before July 20th to avoid incurring interest payments.

During the 2014 tax season, the Department faced a significant increase in fraudulent individual income tax returns filed for 2013. The fraudulent returns increased the workload of the AM team significantly, because many of the returns contained inconsistencies that required manual review. However, the team was able to maintain high productivity for the year, as it has in the past.

In addition, as a result of brainstorming sessions, SWOT analyses, and Process Mapping Sessions, the AM staff and supervisor have identified ways to improve their work processes and have started to make some changes. The experience will also allow them to provide valuable input for the TSM project.

Chart 2.3 shows monthly average postings of documents that were worklisted for FY 2011 through FY 2014.

Chart 2.3 - Account Management Monthly Production, FY 2011 to 2014
Vouchers/Returns Posted and Remaining Worklist



FY 2011 to 2014: Monthly Volume Average Postings of Worklisted Documents

2011 - 16,758

2012 - 14,908

2013 - 14,849

2014 - 18,222

Licensing Section

The Licensing Section processed 8,507 cancellations in FY 2014, an increase of 1% from the 8,411 cancellations processed in FY 2013. The total number of business license applications processed in FY 2014 was 32,473, a 5% increase from the 31,003 applications processed in FY 2013. In line with the Department's goal to expand the use of electronic channels, a primary goal for the Licensing Section was to increase the number of taxpayers applying for business licenses via the Hawaii Business Express, the Department's online business license application channel. To this end, Taxpayer Services Call Center staff encouraged taxpayers to apply for their business licenses online and significant improvements were made on the Department's website for registering a business online. Partly as a result of these initiatives, the number of electronic applications grew from 12,736 in FY 2013 to 13,739 in FY 2014, an increase of 8%.

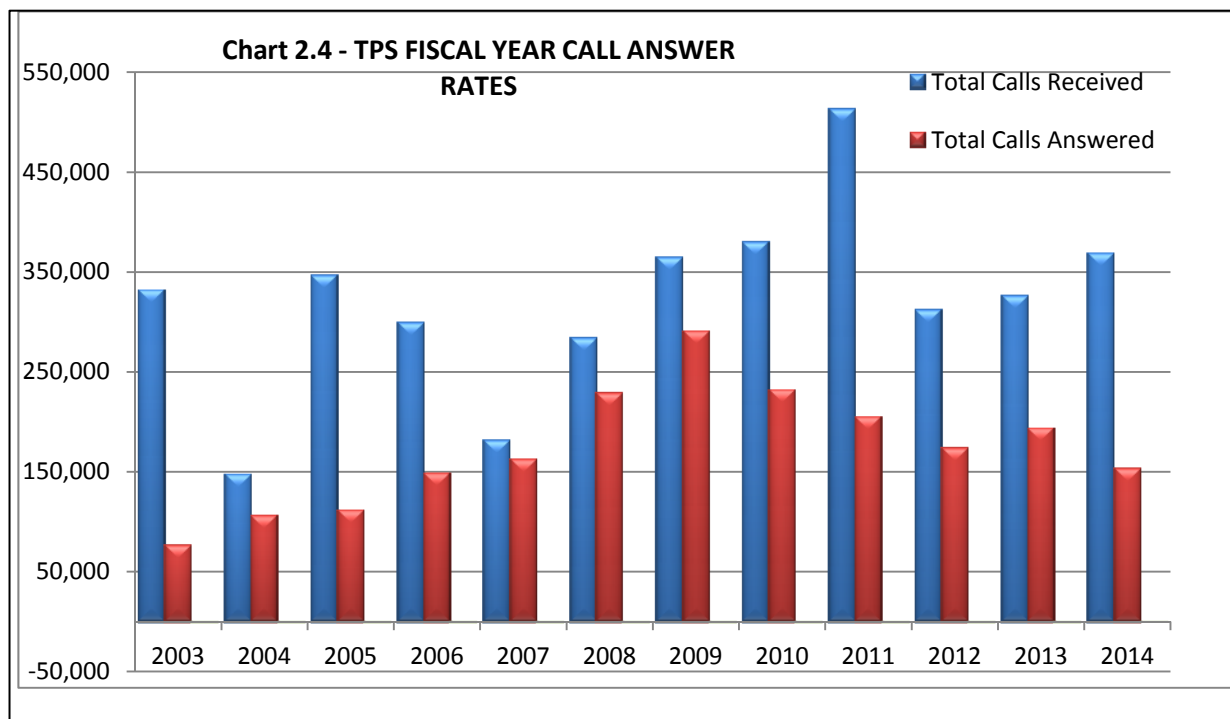
The Taxpayer Services (TPS) Branch has three main functions: (1) to provide efficient customer assistance and information on all taxes administered by the Department (Customer Inquiry Section); (2) to perform computer-based error correction activities to expedite processing, posting

or updating of tax returns, payments and other documents (Account Management Section); and (3) to process, issue and update all licenses and permits issued by the Department in a timely and efficient manner (Licensing Section).

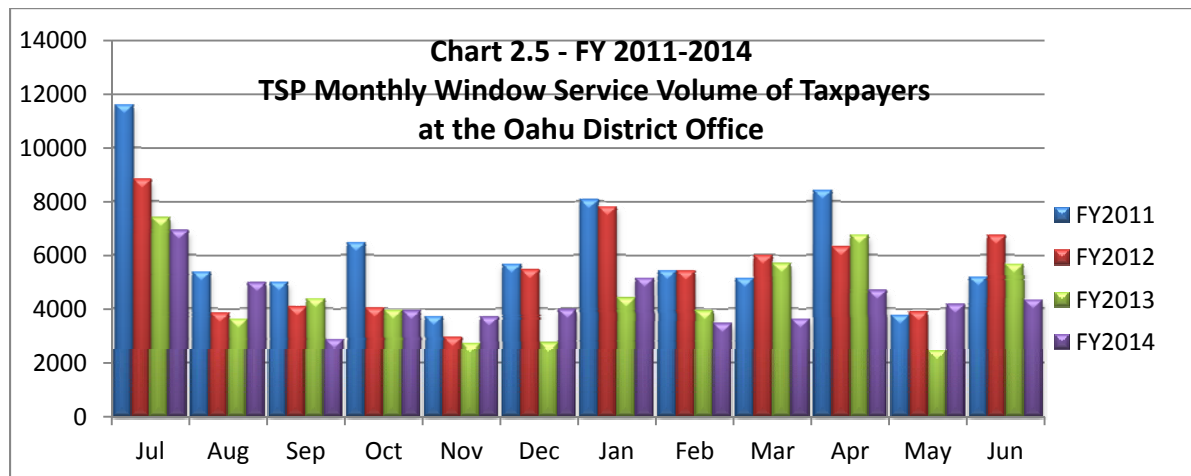
Customer Inquiry Section

With staffing shortages affecting Taxpayer Services, and in particular the Customer Inquiry Section, the call pickup rate for FY 2014 declined from 59% in FY 2013 to 42% in FY 2014. The call statistics for FY 2009 through 2014 are reported below. The following tabulation and Chart 2.4 show statistics on the number of calls and the call answer rate from FY 2003 through 2014.

| <u>FY</u> | <u>Total Incoming Calls</u> | <u>Total Calls Answered</u> | <u>Overall Call Answer Rate</u> |
|-----------|-----------------------------|-----------------------------|---------------------------------|
| 2014 | 369,010 | 153,286 | 42% |
| 2013 | 326,501 | 193,988 | 59% |
| 2012 | 312,441 | 173,948 | 56% |
| 2011 | 513,503 | 205,383 | 40% |
| 2010 | 380,142 | 232,471 | 61% |
| 2009 | 364,804 | 291,228 | 80% |
| 2008 | 284,217 | 228,875 | 81% |
| 2007 | 181,663 | 162,576 | 90% |
| 2006 | 299,582 | 148,981 | 50% |
| 2005 | 346,972 | 111,846 | 32% |
| 2004 | 147,514 | 106,146 | 72% |
| 2003 | 332,399 | 76,392 | 23% |



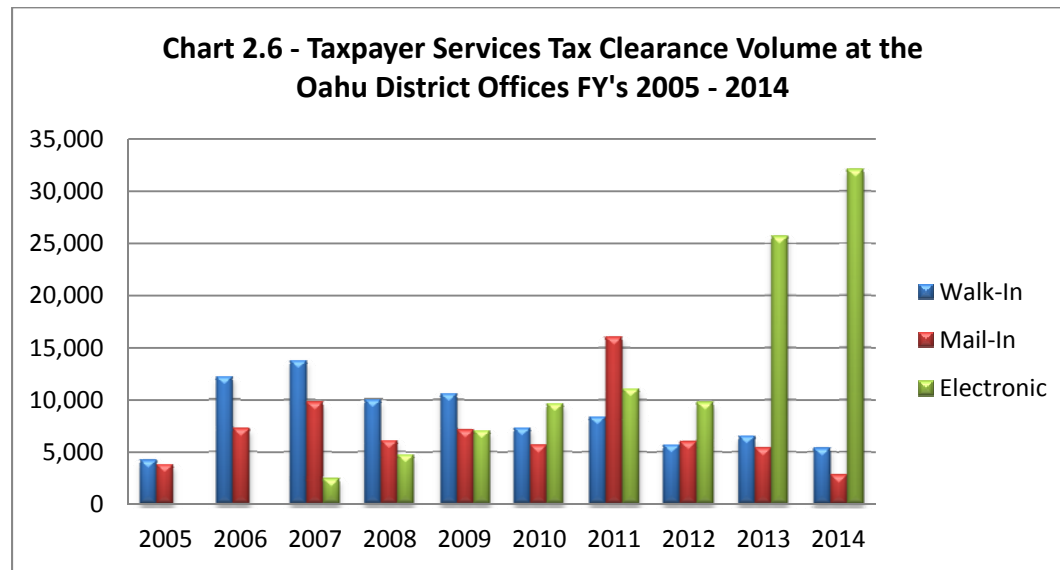
With greater emphasis placed by the Department on electronic filing, the number of walk-in taxpayers serviced on Oahu has been declining. A total of 6,131 walk-in taxpayers were serviced in FY 2011, whereas only 4,290 walk-in taxpayers were serviced in FY 2014, a decline of 30%. Chart 2.5 shows the average monthly window service volume from FY 2011 to FY 2014.



FY 2011 to 2014 Average Monthly Window Service Volume Per Year

2014 - 4,290
2013 - 4,451
2012 - 5,416
2011 - 6,131

Act 190, SLH 2011, which took effect July 1, 2011, reduced the dollar threshold for Hawaii Compliance Express for vendors doing business with State and county agencies from \$15,000 to \$2,500. The change also required vendors to provide Certificates of Compliance via the Hawaii Compliance Express (HCE) instead of paper tax clearances, which resulted in dramatic increases each subsequent year in electronic processing of tax clearances. Although the requirement to be registered on HCE has since been relaxed, the volume of electronic tax clearances has continued to grow: 32,092 HCE electronic tax clearances were processed in FY 2014, compared to 25,691 in FY 2013 and 9,777 in FY 2012. Chart 2.6 shows tax clearances at the Oahu District Office from FY 2005 through FY 2014:



2.3 COMPLIANCE DIVISION

2.3.1 Overview

The objective of the Compliance Division is to maximize taxpayer compliance with Hawaii's tax laws in a consistent, uniform, and fair manner. The Compliance Division is composed of the Oahu Office Audit Branch, the Oahu Field Audit Branch, the Oahu Collections Branch, and the Maui, Hawaii, and Kauai District Tax Offices. In addition to these branches, there are also the Special Enforcement Section (SES) and Criminal Investigation Section (CIS). The Division has the following three programs to meet the objectives of the voluntary compliance, self-assessment tax system: (1) auditing/examination, (2) collection, and (3) taxpayer services (information dissemination).

2.3.2 Office Audit Branch

The Office Audit Branch performed examinations and audits to enhance voluntary compliance. In FY 2014, the number of audits completed by the Office Audit Branch was 9,019 cases, an increase of 19.3% (1,456 cases) compared to FY 2013, and the total dollars assessed was \$35.5 million, an increase of 49.2% (\$11.8 million) compared to FY 2013. The majority of the audits were performed by Oahu Office Audit Branch, followed closely by the Hawaii District Office. In FY 2014, the Office Audit section handled the processing of the Estate and Transfer Tax returns and collected \$2.7 million for estate tax returns. Charts 2.7 and 2.8 (on the following page) show the number of audits completed and the dollars assessed by Office Audit for FY 2005 through FY 2014.

2.3.3 Field Audit Branch

Similar to the Office Audit Branch, the Field Audit Branch performed examinations and audits to enhance voluntary compliance. The Field Audit Branch handled audits involving intricate auditing procedures. In FY 2014, the number of audits completed by the Field Audit Branch was 183 cases, an increase of 32.6% (45 cases) compared to FY 2013, and the total dollars assessed was \$63.5 million. Charts 2.9 and 2.10 show the number of audits completed and the dollars assessed by Field Audit for FY 2005 through FY 2014.

Chart 2.7 - Office Audit: Number of Completed Audits

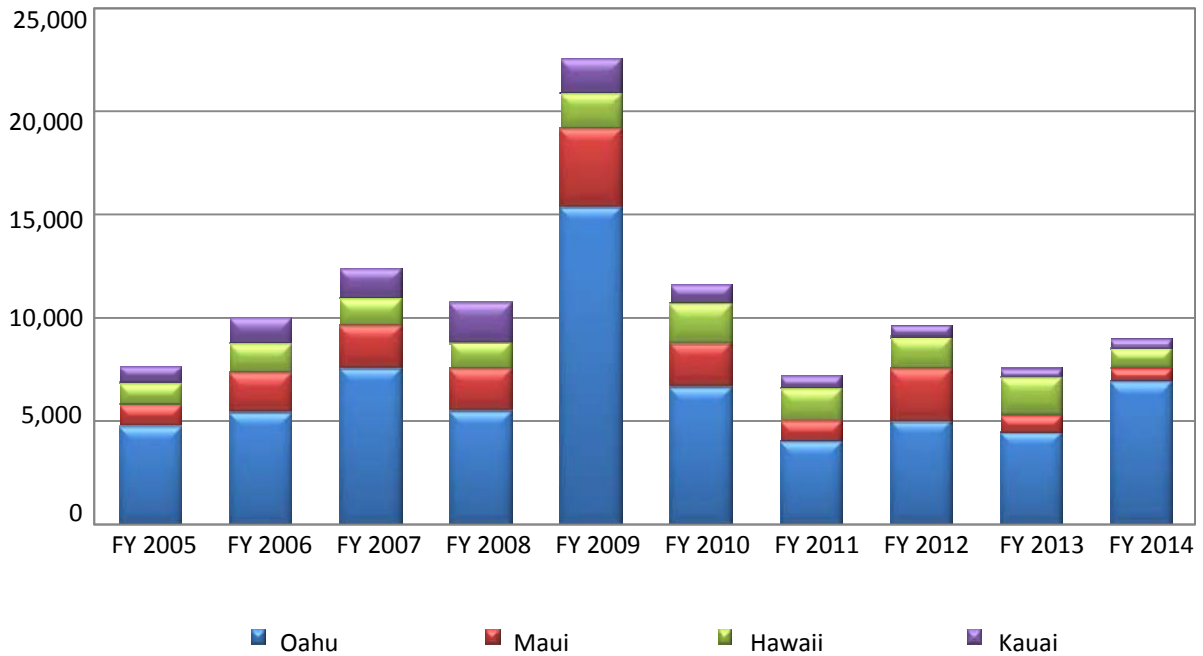


Chart 2.8 - Office Audit: Dollars Assessed

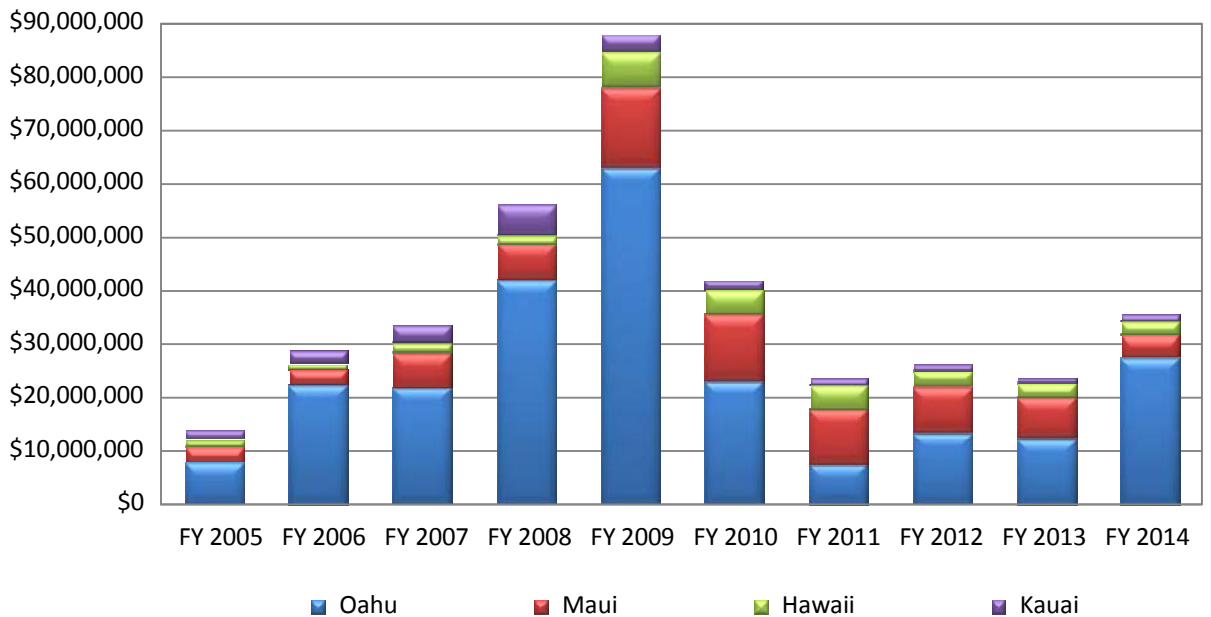


Chart 2.9 - Field Audit: Number of Completed Audits

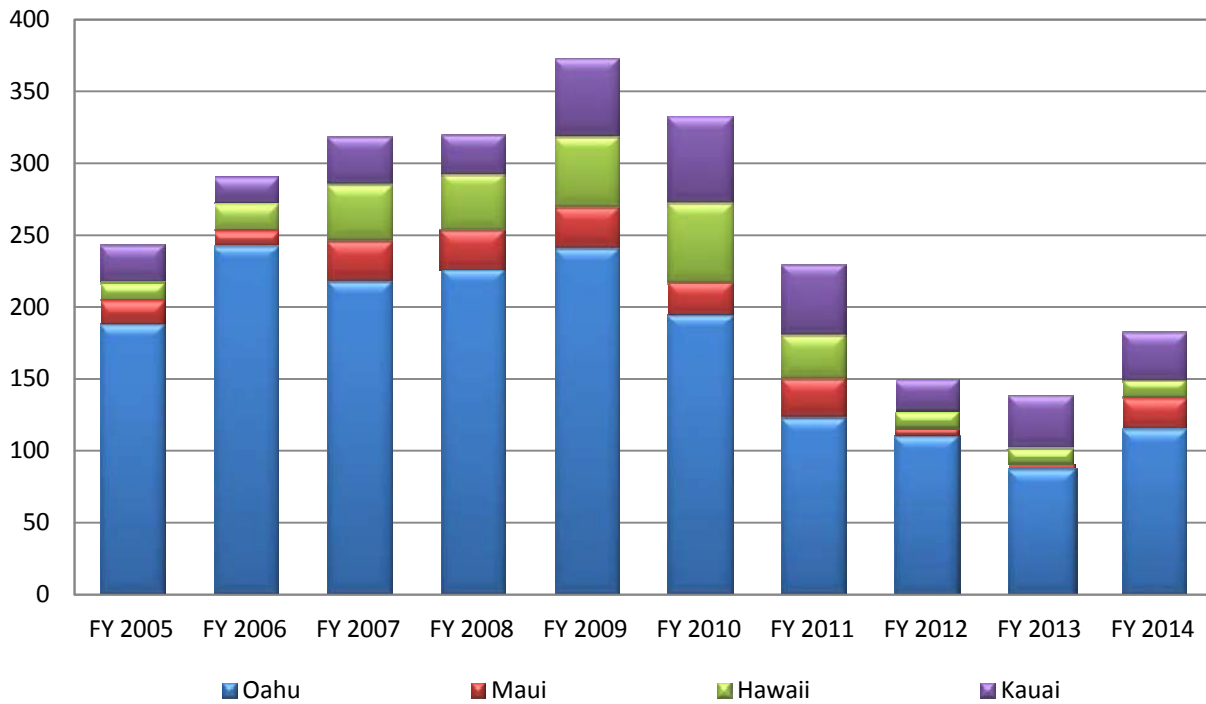
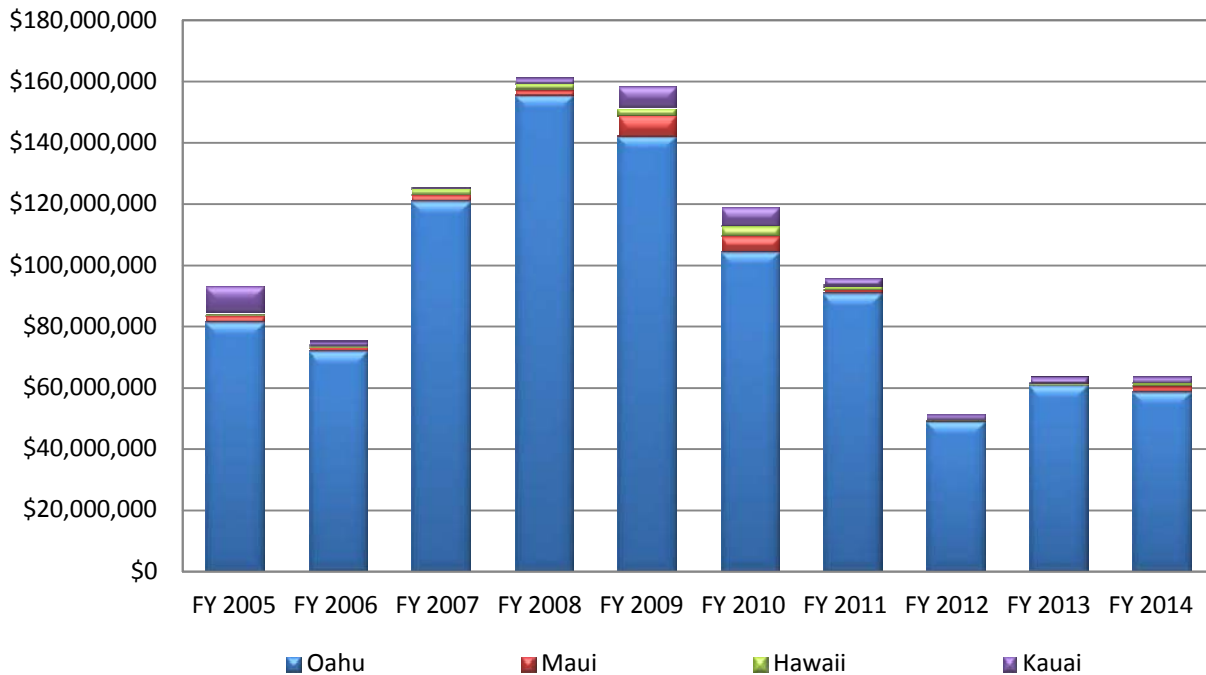
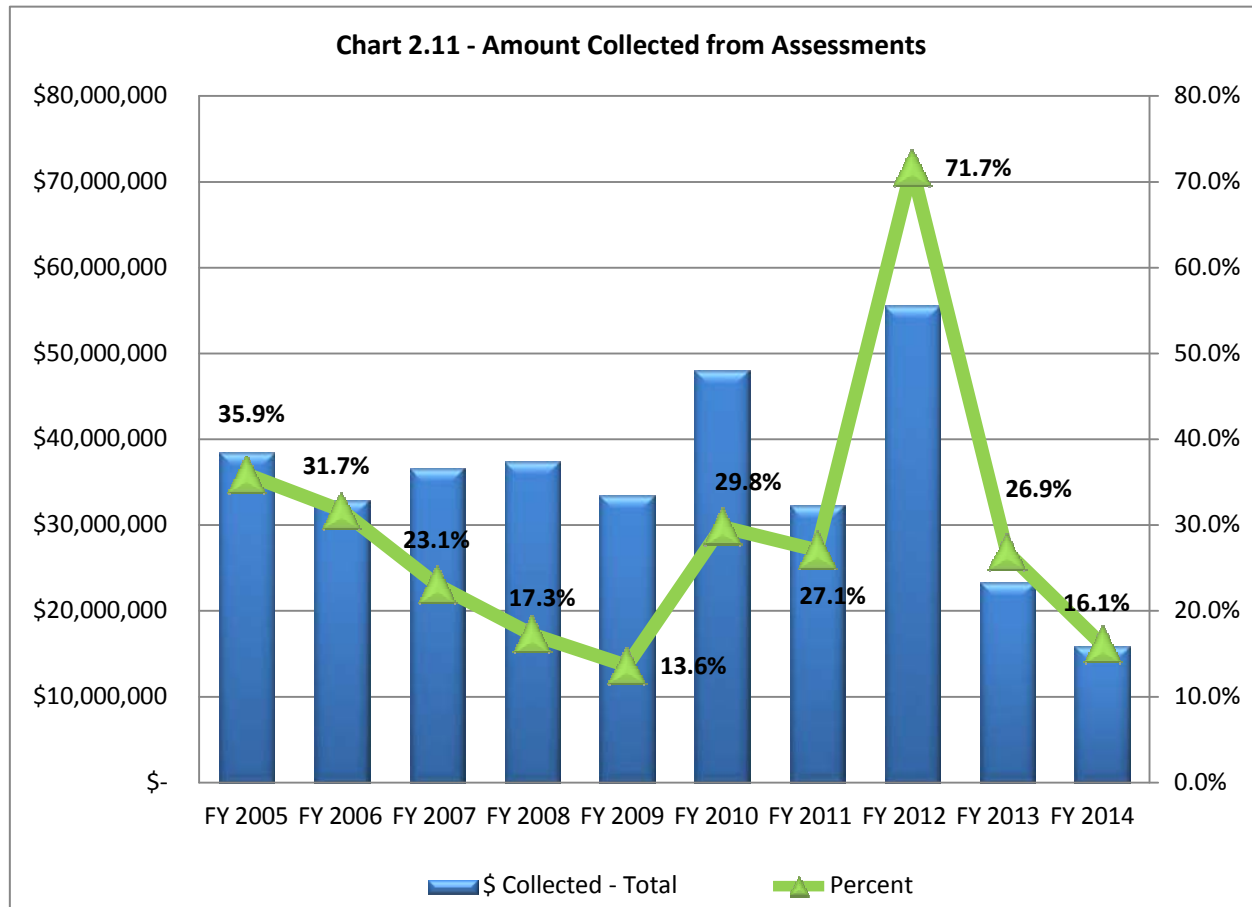


Chart 2.10 - Field Audit: Dollars Assessed



2.3.4 Revenue – Office and Field Audit Assessments

The amount collected at the time the audits were closed and prior to the mailing of any billing notices decreased from \$23.4 million in FY 2013 to \$15.9 million in FY 2014.⁶ The figure for FY 2014 represents a collection rate of 16.1%. Chart 2.11 summarizes the amounts collected from assessments made by the Office and Field Audit Branches for FY 2005 through FY 2014. Table 2.1 shows the amounts assessed for FY 2014.



⁶ Dollars assessed are assessments generated during the 2014 fiscal year. The dollar amount collected is for collections during the 2014 fiscal year and may include assessments and settlements from prior fiscal years.

TABLE 2.1 – AMOUNTS ASSESSED FOR FY 2014

| | <u>Office Audit</u> | | | <u>Field Audit</u> | |
|---------------|---------------------|------------------|--|--------------------|------------------|
| | | | | | |
| | Number of Audits | Dollars Assessed | | Number of Audits | Dollars Assessed |
| Oahu | 6,897 | \$ 27,631,026 | | 115 | \$ 58,800,848 |
| Maui | 717 | \$ 3,938,429 | | 22 | \$ 1,487,737 |
| Hawaii | 949 | \$ 2,678,954 | | 13 | \$ 1,186,967 |
| Kauai | 456 | \$ 1,289,637 | | 33 | \$ 2,011,917 |
| | | | | | |
| Total FY 2014 | 9,019 | \$ 35,538,046 | | 183 | \$ 63,487,469 |
| Total FY 2013 | 7,563 | \$ 23,762,110 | | 138 | \$ 63,307,680 |
| | | | | | |
| Difference | 1,456 | \$ 11,775,936 | | 45 | \$ 179,789 |

2.3.5 Special Projects

The Oahu Office Audit Branch conducted the following special project during the fiscal year:

- Renewable Energy Tax Credit: The review of the tax credits claimed resulted in \$1,324,686 in assessments and adjustments.

The Oahu Field Audit Branch conducted the following special projects during the fiscal year:

- Miscellaneous Assessments: The Field Audit Branch assisted the Attorney General's office and issued additional assessments to certain online travel companies. The additional assessments for FY 2014 totaled \$166.4 million. The cases have been appealed. The number of audits and dollars assessed are not included under Field Audit – Oahu in the previous section.
- Federal Contractors Project: This project, which targets unlicensed contractors working on federal installations, was started in 1983 and is an ongoing activity. Nine audits were completed and resulted in \$1.5 million in assessments.
- Referral Cases from Criminal Investigation Unit: Thirteen cases that were either originally considered for possible criminal prosecution or that arose pursuant to a criminal investigation were completed, resulting in \$16.9 million in assessments.
- Multistate Tax Commission: During this fiscal year, six audit cases were completed that resulted in \$1.2 million in assessments.

2.3.6 Taxpayer Assistance Provided

During FY 2014, the personnel in neighbor island district tax offices helped taxpayers properly file numerous tax returns and other documents over the telephone, at the service counter, and via correspondence. The Oahu Office Audit, Field Audit, and Collection units also provided

support services to the neighbor island district tax offices and to the Oahu Taxpayer Services Branch when requested. Table 2.2 summarizes the number of times that taxpayer assistance was provided by the Maui, Hawaii, and Kauai District Tax Offices:

TABLE 2.2 – TAXPAYER ASSISTANCE PROVIDED BY MAUI,
HAWAII AND KAUAI DISTRICT OFFICES

| | | | | Difference | |
|----------------|---------|---------|--|------------|------------|
| | FY 2014 | FY 2013 | | Number | Percentage |
| Counter | 74,607 | 69,804 | | 4,803 | 6.9 |
| Phone Services | 53,298 | 54,508 | | -1,210 | -2.2 |
| Tax Clearances | 5,486 | 6,241 | | -755 | -12.1 |
| Correspondence | 21,395 | 12,157 | | 9,238 | 76.0 |

The taxpayer services sections provide accessible telephone and counter services despite the centralization of customer services within the Oahu TSP Division. The districts continue to receive a steady flow of telephone inquiries, and can assist with any tax inquiry with the use of the statewide tax data system.

The assistance provided to taxpayers is part of the Compliance Division’s continuing emphasis on taxpayer education and problem resolution in its contacts with taxpayers. The Compliance Division continues to believe in the importance of maintaining taxpayers’ willingness to accurately and voluntarily comply with the State’s tax laws. This “taxpayer enabling and empowering activity” will continue to be emphasized.

2.3.7 Collection Branch

The Compliance Division’s Tax Collections program consists of the Oahu Collection Branch and the Collections Sections in the Maui, Hawaii, and Kauai District Tax Offices. Collections of delinquent taxes totaled \$225.5 million for FY 2014, compared to the \$192.7 million in delinquent tax collections in FY 2013, an increase of \$32.8 million. Chart 2.11 shows delinquent collections for FY 2005 through FY 2014.

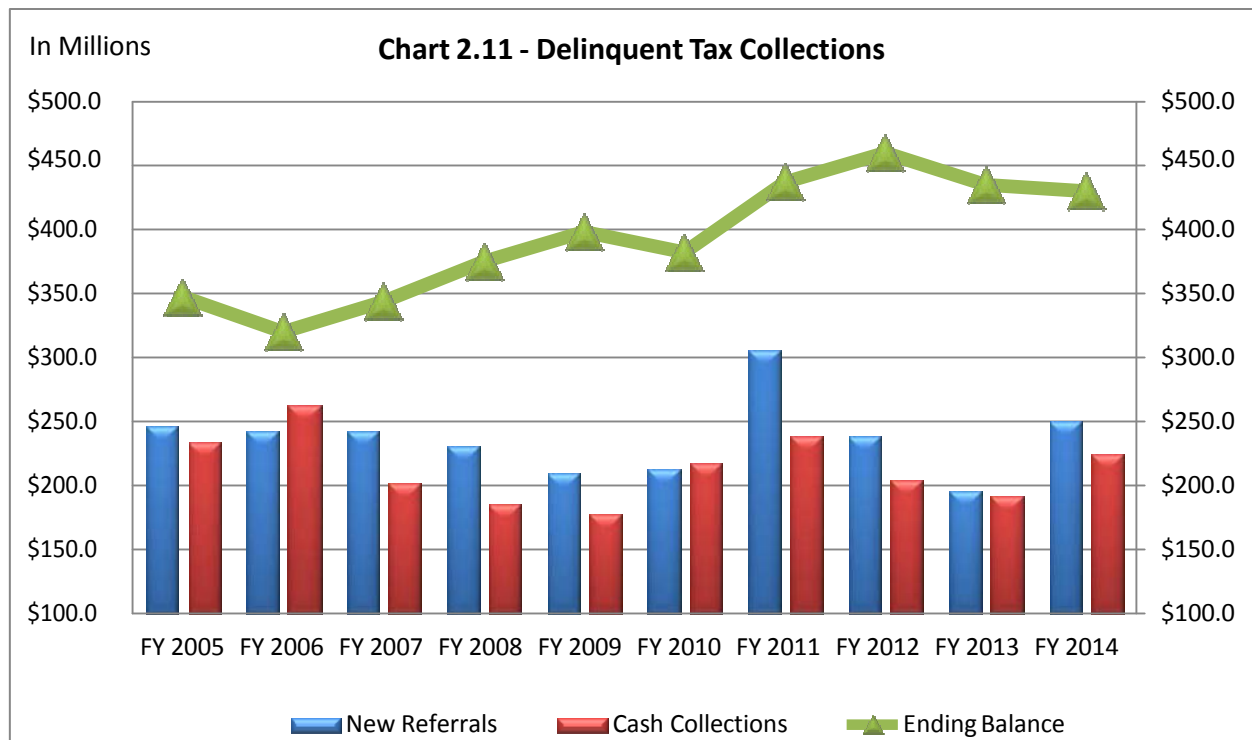


Table 2.3 shows major performance measures for FY 2014 and FY 2013.

TABLE 2.3 – MAJOR PERFORMANCE MEASURES FOR FY 2014 AND FY 2013

| Measure | FY 2014 | FY 2013 | Difference | |
|--|----------|----------|------------|------------|
| | | | Amount | Percentage |
| Total Delinquent Tax Balance (\$ Millions) | \$ 429.9 | \$ 434.9 | \$ (5.0) | (1.1) |
| Total New Delinquent Referrals (\$ Millions) | \$ 251.7 | \$ 196.9 | \$ 54.8 | 27.8 |
| Total Cash Collected (\$ Millions) | \$ 225.5 | \$ 192.7 | \$ 32.8 | 17.0 |
| Uncollectible Tax Write-Offs (\$ Millions) | \$ 31.3 | \$ 29.1 | \$ 2.2 | 7.6 |
| Payment Plans Initiated | 33,025 | 21,624 | 11,401 | 52.7 |
| Tax Liens Filed | 3,553 | 3,399 | 154 | 4.5 |
| Levies Served | 20,081 | 20,690 | (609) | (2.9) |

2.3.8 Criminal Investigation Section

During FY 2014, the Criminal Justice Division of the Department of the Attorney General filed complaints or indictments against five taxpayers for violating Hawaii State tax laws as described in Hawaii Revised Statutes §231-34, 231-35 and 231-36. The Offices of the Prosecuting Attorneys for Honolulu, Maui and Kona also filed complaints in their respective counties and combined, all agencies filed a total of nine complaints this fiscal year. The nine complaints filed against these taxpayers accounted for over \$256,440 in unpaid taxes (excluding civil

assessments, penalties and interest). Pleas of no contest or guilty were entered in four cases and five cases are still pending further action.

Including the cases referenced above, four other cases were adjudicated in FY 2014 that were charged in the prior fiscal year. These cases accounted for over \$22 million dollars in gross income that was not reported to the tax department and over \$850,541 in unpaid taxes. The courts imposed criminal fines of \$30,600 and 75 hours of community service in these cases. A total of \$1,300,356 in unpaid taxes, penalties and interest was collected during FY 2014 by the Criminal Investigations Section.

Despite the amount of complaints and indictments this fiscal year, the Criminal Investigations Section continues to receive numerous referrals and reports of potential cases from both internal and external sources. The section is a critical part of the Department of Taxation and should continue with its efforts of deterrence through the successful prosecution of tax offenders. Steady media exposure can also encourage better tax compliance and help to fulfill the Department's mission of administering the tax laws of the State of Hawaii in a consistent, uniform and fair manner.

Cases Worthy of Note

(These cases are described in section 3.2.4 below.)

2.3.9 Special Enforcement Section

Act 134, SLH 2009, provided resources for the creation of the Special Enforcement Section (SES), which is a unique initiative to increase compliance by businesses conducting a significant number of difficult-to-trace cash transactions in what has been called the "cash economy." SES began conducting investigations in FY 2010.

In FY 2014 three new investigators started, but the unit was only fully staffed for seven months. Despite staffing shortages and changes in staff in the fiscal year, the unit produced the following results in FY 2013 and FY 2014.

SES reports the following statistics:

| | <u>FY 2013</u> | <u>FY 2014</u> |
|---|----------------|----------------|
| Complaints filed by anonymous persons | 136 | 195 |
| Vendors educated as to how to comply with tax law | 885 | 1,005 |
| Site visitations throughout the State of Hawaii | 54 | 18 |
| Number of Investigations completed | 10 | 31 |
| Number of Referrals sent for Assessment | 10 | 22 |
| Total Liability on Secured Returns | \$ 1,496,206 | \$ 996,211 |
| Revenue Collected | \$ 679,570 | \$ 805,776 |

2.4 STAFF OFFICES

2.4.1 Administrative Services Office

2.4.1.1 Fiscal Office

The Administrative Services Office submitted the supplemental budget for fiscal year 2015 to the 2014 Legislature. For fiscal year 2015, \$27.9 million was appropriated for the Department.

For fiscal year 2014, \$24.1 million was appropriated for the Department. In discharging its duties and responsibilities, the Department of Taxation incurred operating expenses of \$20.9 million for fiscal year 2014. Net collections of taxes administered and collected by the Department were \$6.24 billion in fiscal year 2014. As a result, the cost to collect \$100.00 of taxes was about \$0.33.

2.4.1.2 Personnel Management

The Department of Taxation's Personnel Office is a comprehensive human resources program that focuses on the Department's most valuable asset - its employees. The Office's functions include the following: Recruiting, hiring, and retaining a diverse population of qualified personnel; providing employment and orientation services; handling contract management and labor relations; ensuring federal/state compliance; ensuring diversity/EEO compliance; coordinating and maintaining employee benefits; performing pre-payroll administration and processes; handling policy development and administration; performing job classifications; providing job description analysis; handling compensation; handling employee relations; administering an employee assistance program; maintaining personnel records; handling administration of performance evaluations; and handling retirement processing.

The Personnel Office expanded its mission to provide high quality service to all prospective, current and past employees, to treat these individuals with respect, and to provide them with excellent care and attention from their first inquiries about position vacancies, services and programs, through retirement. We are committed to recruiting, hiring and retaining the highest qualified individuals to meet the goals of our organization, while maintaining confidentiality, honesty, and impartiality, and promoting positive employee relations and performance. We encourage an atmosphere where employees feel valued and recognized for their efforts and try to create an environment that fosters a positive attitude and a creative spirit among our employees. We are committed to ensuring that all decisions related to employment are fair, are based on principles of equal opportunity, and are in accordance with policies and procedures of the Department, with civil service rules and mandates, with federal and state laws, and with collective bargaining agreements. By making this commitment, we will be able to maintain a high level of mutual trust, integrity and respect.

Within the past year, the Department has been engaged in two significant initiatives simultaneously—the ERP (Enterprise Resource Planning) program (also known as the SURF Program) and the TSM (Tax System Modernization) program. The ERP is an integrated technology system, aimed at establishing standardized systems across all State agencies. The intent is to integrate the functions, data and processes across all State Executive branch departments into a

single system, including human resources, payroll, time and attendance, grants management, assets management, acquisitions, and budget and finance functions. As required by the Governor's directive, representatives from various State departments were deployed or delegated to participate in the planning and implementation process. The Department's Personnel Office was an active participant in the process and attended ERP statewide personnel meetings that were held every two to three weeks. The TSM program is a new technology system to re-engineer business processes and to improve the efficiency of operations within the Department. It was established in order to modernize the Department's tax system and to streamline its business processes. It required many departmental personnel to be reassigned, creating more classification work for the Personnel Office. To align with TSM and to ensure efficiency of services, initial steps were taken for reorganization within the Department.

The Personnel Office continued to try to fill vacancies within the Department. This proved to be a challenge due to the specialized nature of many of the positions. The Personnel Office attended numerous job fairs at the Blaisdell Center and at various colleges. In addition, the first DOTAX Student Internship Program was initiated. Five student interns were selected—two from Leeward Community College, two from the University of Hawaii at Manoa (including one from the Shidler School of Business), and one from Hawaii Pacific University. The Program helped the students understand what it is like to work for the State by temporarily employing them with the Department while also allowing them to simultaneously earn college credit. The students were detailed to the TSP Division, the Rules Office, the Special Enforcement Section, and the Personnel and Fiscal Offices. All the parties involved reported positive experiences with the program.

The Department had 382 authorized permanent positions for FY 2014, which was one less than the previous year. Employees were geographically distributed as follows: Oahu, 315; Hawaii, 27; Maui/Molokai/Lanai, 24; and Kauai, 16. Personnel Actions completed during the year included 9 exempt hires, 30 new civil service hires, 102 temporary tax season hires, 17 promotions, 7 transfers, 10 retirements, and 15 resignations. The tabulation below shows the staffing pattern from FY 2011 through FY 2014.

STAFFING PATTERN
(Number of Authorized Permanent Positions)

| <u>Organization/Operating Program</u> | <u>FY 2015</u> | <u>FY 2014</u> | <u>FY 2013</u> | <u>FY 2012</u> | <u>FY 2011</u> |
|---------------------------------------|----------------|----------------|----------------|----------------|----------------|
| Headquarters Administration | 75.0 | 75.0 | 72.0 | 71.0 | 62.0 |
| Tax Services and Processing Division | 118.0 | 118.0 | 122.0 | 123.0 | 123.0 |
| Compliance Division | <u>191.0</u> | <u>189.0</u> | <u>189.0</u> | <u>179.0</u> | <u>179.0</u> |
| TOTAL | 384.0 | 382.0 | 383.0 | 373.0 | 364.0 |

2.4.2 Rules Office

The Rules Office is comprised of the Rules staff and the Technical Section. The function of the Rules Office is to serve as a resource for complex policy recommendations and complex internal support. The Rules Office also assists in the Department's implementation of new legislation and in creating and maintaining the Department's tax forms and instructions.

2.4.2.1 Rules Staff

The Rules staff serves as the Department's internal advisory arm to the Director of Taxation on tax policy and advises the Director's Office and the Department on legislative and tax policy issues. Litigation and other external legal matters are handled exclusively by the Tax Division of the Department of the Attorney General.

In addition, the Rules staff assists, counsels, and represents the Department's compliance personnel with tax disputes and other administrative tax controversies. For example, the Rules staff provided assistance to the Department's compliance function in interpreting issues under audit, settlement negotiations and closings, and appeared on behalf of the Department before the Boards of Review. The Rules staff also assisted the Tax Division of the Department of the Attorney General with the Department's tax cases that are being litigated.

The Rules staff also testified at legislative hearings on behalf of the Director, provided training for Department personnel, and spoke at several workshops for tax practitioners. For the 2014 legislative session, the Rules staff drafted and submitted thirteen bills sponsored by the administration, which were submitted to both the House of Representatives and the Senate. Prior to the start of the legislative session, the Rules staff also reviewed and commented on proposed tax legislation submitted by other executive departments.

After reviewing the bills introduced to the 2014 Legislature, the Director's Office and the Rules staff determined there were approximately 250 measures proposing tax law changes and analyzed them in depth. The measures were tracked throughout the legislative session and written testimonies were prepared each time a tax measure was heard by the Legislature. In addition, the Rules staff drafted letters to legislative committee chairs to respond to specific questions raised during hearings or to address specific concerns of committee members.

During the fiscal year, the Rules staff prepared Tax Announcements, Tax Information Releases, letter rulings, Administrative Directives, and other publications. During FY 2014, one official Tax Information Release and twenty-six Tax Announcements were issued. Since 2009, when it became the Department's policy to publicly release taxpayer letter rulings in redacted form, 60 redacted letter rulings have been released.

In FY 2014, the Department promulgated administrative rules relating to the renewable energy technologies income tax credit provided under Hawaii Revised Statutes (HRS) § 235-12.5. The temporary rules went into effect on November 16, 2012 and became permanent effective January 2, 2014. The rules apply to systems placed into service on or after January 1, 2013 and provide specific guidelines to determine the number of "systems" based on the total output capacity of the equipment installed.

Additionally, the Department issued temporary administrative rules relating to cash economy enforcement and citations provided under HRS § 231-91 through § 231-100. The temporary rules went into effect March 7, 2014, and provide specific guidelines relating to cash economy enforcement, with particular regard to the issuance of cease and desist citations, how fines will be issued, and procedures to contest the citations.

The Rules staff also reviewed and certified 149 requests for the high technology business investment tax credit and 41 requests for the credit for research activities pursuant to HRS § 235-110.9 and HRS § 235-110.91, respectively.

2.4.2.2 Technical Section

The Technical Section is tasked with varying responsibilities to carry out the Department's projects, goals and initiatives, and to support the Department's operational needs. Specifically, the Technical Section assists and advises all divisions within the Department, as well as outside parties such as individual and corporate taxpayers and tax professionals, on complex areas of state tax. For FY 2014, the Technical Section responded to 1,180 email inquiries and 5,925 telephone inquiries. It also responded to 76 formal requests, including requests for letter rulings or information letters, determinations of tax status (such as for eligibility for the general excise tax exemptions for air-pollution control facilities), multi-level marketing agreements, and tax surveys and questionnaires from other government agencies, educational institutions, and major tax service product providers.

The Technical Section also reviews, researches, analyzes, and provides comments and recommendations on the technical and procedural aspects of legislative bills, administrative rules, and tax information releases. The staff is responsible for revising or creating the State's tax forms and instructions, incorporating all applicable federal and state tax law changes. For FY 2014, the Technical Section reviewed 342 tax forms and 53 tax form instructions. It also developed two new tax forms and one new tax form instruction, and it terminated four tax forms and one instruction that were determined to be obsolete.

Other duties of the Technical Section include analyzing and reviewing certain applications for tax exemptions. In FY 2014, 180 applications for an exemption from the general excise tax were received, 113 applications were reviewed and processed, and 210 applications are pending further action. In addition, 3,380 applications for conveyance tax exemptions were reviewed and processed.

2.4.3 Tax Research and Planning Office

The following are the main functions of the Tax Research and Planning ("TRP") Office: (1) prepare reports on data collected by the Department, including reports on statewide tax collections, on the income patterns of individual and business taxpayers, and on tax credits claimed by taxpayers; (2) provide administrative and technical support to help the Council on Revenues to prepare its forecasts of General Fund tax revenues and total personal income; (3) provide economic and statistical analyses to help the Department execute its policies and programs; (4) prepare reports on the revenue consequences of proposed tax legislation for the Legislature, and for the Governor and other agencies in the Administration; and (5) provide administrative and technical support for the Tax Review Commission when it is in session.

The TRP Office prepares the following reports on a monthly, fiscal year, and calendar year basis:

(1) State Tax Collections and Distributions; (2) General Excise and Use Tax Collections; (3) Liquid Fuel Tax Base and Collections; (4) Liquid Fuel Tax Allocation by Fund; (5) Liquor Tax Collections and Permits; (6) Tobacco Tax Collections and Licenses, and (7) Preliminary Comparative Statement of General Fund Tax Revenues.

In fiscal year 2014, the TRP Office worked on the Department of Taxation's Annual Report: 2012–2013, which was completed and submitted in March of 2014. The Office also published a report on tax credits claimed by Hawaii taxpayers in tax year 2011. Owing to staff shortages, the reports on tax credits had been discontinued since 2007, when the report for tax year 2005 was issued. Statistics from the report are used to estimate the revenue consequences of legislative proposals and to inform policy officials about the revenue costs of the tax credits.

For the 2014 Legislative session, TRP staff reviewed and tracked tax-related legislative bills and resolutions, and prepared more than 350 revenue estimates for various drafts of the bills. Revenue estimates were also prepared for various proposals in response to requests from the Administration, legislators and others.

An important function of the TRP Office is to provide administrative and technical support to help the Council on Revenues produce its forecasts of tax revenues. The seven members of the Council are responsible for forecasting State General Fund revenues and the State's total personal income. The Council provides forecasts of State revenue for the current and six subsequent fiscal years. The forecasts are due on September 10, January 10, March 15, and June 1 of each year. The forecasts are used by the Governor and by the Legislature to develop and administer the State's budget. The Council also forecasts total personal income (TPI) for the current and immediately following calendar years. The TPI forecasts are due on August 5 and November 5 of each year. The growth in Hawaii total personal income is used to set the ceiling for expenditures from the State's General Fund, as required by the State's Constitution.

TRP staff applied advanced econometric modeling techniques to data on State tax collections and to data on other economic variables to help the Council produce its forecasts. The Council's last General Fund forecast for fiscal year 2014 was produced on May 29, 2014. The forecast called for tax collections dedicated to the Fund to shrink by 0.4% compared with fiscal year 2013. Tax collections actually fell by 1.8%, as General Fund collections shrank from \$5.47 billion in fiscal year 2013 to \$5.37 billion in fiscal year 2014. The Council's last forecast for total personal income for calendar year 2013 was produced on October 31, 2013 and called for growth of 3.1% over calendar year 2012. The actual growth was 2.9%, from \$62.3 billion in 2012 to \$64.1 billion in 2013.

The TRP Office updated the econometric model that was developed under a contract with UCLA Anderson Forecast to predict General Fund tax collections based on the Council's forecasts for economic variables. The Office also continued to provide results based on its own model, which is now similar in form to the model developed by UCLA Anderson Forecast. At the request of the Council on Revenues, the TRP Office also provides the results of a single-equation regression to predict General Fund tax revenues.

2.4.4 Information Technology Services Office

The Information Technology Services (ITS) Office is responsible for providing technical support for the Departments' computerized tax systems and applications, for its local area network, and for networking-related components and infrastructures. During FY 2014, the ITS Office continued to focus on managing, administering, and maintaining the Integrated Tax Information Management System (ITIMS), the local area network, and the associated components and infrastructures.

Key initiatives continued or accomplished during FY 2014 include the following:

- In accordance with Act 60, Session Laws of Hawaii 2009 and Act 97, Session Laws of Hawaii 2011, system modifications were made to increase the standard deduction and personal exemption amounts for 2013 Individual Income Tax forms. System modifications were implemented by December 2013.
- In accordance with Senate Bill 1349, Session Laws of Hawaii 2013, system modifications were made to include a Tax Credit for Research Activities for 2013 Individual Income Tax forms. System modifications were implemented by June 2014.
- The Department's website at <http://tax.hawaii.gov> was redesigned to conform to the new standards established by the Office of Information Management & Technology (OIMT), as part of the State's transformation plan. The redesign improved the organization and enhanced navigation on the website, and enabled a new search function to be added that can search for text within documents (PDF, Word, Excel, etc.) that are posted.
- The Tax Refund Search and Tax License Search websites were upgraded for use by mobile devices, and these also conform to the new OIMT standards.
- The Modernized Electronic Filing (MEF) program was updated to support two additional federal attachments (1099-DIV and 1099-OID) to the N-11 and N-15 individual returns.
- The daily transfer of EFT Payment Plan files from the Department to First Hawaiian Bank was automated to replace an old manual process. In addition, file transfers of ACH Credit and Returned Refund files between the Department and First Hawaiian Bank were upgraded to a more secure File Transfer Protocol (FTP) connection.
- Modifications were made to all system generated taxpayer correspondence letters to mask the Federal Employee Identification Number (FEIN) and to be in compliance with the Hawaii Revised Statute 487J (HRS 487J).

Items that will most likely continue into the next reporting period include the following: 1) the Tax System Modernization Project; 2) annual Tax Law Changes; 3) strengthening measures to detect and stop fraudulent refunds; 4) active participation in the state-wide Enterprise Resources Planning Project; 5) further strengthening of the security for ITIMS applications, as well as providing support for network and database infrastructures.

2.4.5 System Administration Office

The System Administration Office provides business and technical support for implementing changes to the computer system that are mandated by tax law changes or requested by users. During fiscal year 2014, the following projects and changes were initiated or completed.

Modernized Electronic Filing (MeF)

Modernized Electronic Filing (MeF) is a program that allows electronic filing of federal and state returns through the Internal Revenue Service (IRS). Despite a 50% reduction in staffing, MeF for the tax year 2013 was implemented timely and successfully in January 2014. The Department processed approximately 447,000 Individual income returns via MeF during the first six months in 2014, an increase of 11% from the previous year.

Quality Assurance on Refund Requests

As an ongoing effort, this section is working closely with the Compliance and Taxpayer Services & Processing divisions to facilitate the refund review process and to improve return edits and validations.

487J Social Security Number Protection

Section 487 of the Hawaii Revised Statute places limitations on the use of Social Security Numbers in correspondence or other communications with the taxpayer that may be inadvertently misdirected. The required modifications to correspondence templates are on-going.

2.5 MANAGEMENT PERSONNEL

As of June 30, 2014

OFFICE OF THE DIRECTOR

Director of Taxation..... Frederick D. Pablo
Deputy Director of Taxation..... Joshua A. Wisch

STAFF OFFICES

Public Information Officer..... Mallory Fujitani
Rules Officer..... Ted Shiraishi
 Acting Technical Section Supervisor..... Adriane N. Aarona
Tax Research & Planning Officer..... Donald Rousslang
 Senior Economist..... Yvonne Chow
Acting Information Technology Services Manager..... David Okuma
Administrative Services Officer..... Vacant
 Personnel Officer..... Sharene Moriwaki
Taxpayer Advocate..... Vacant

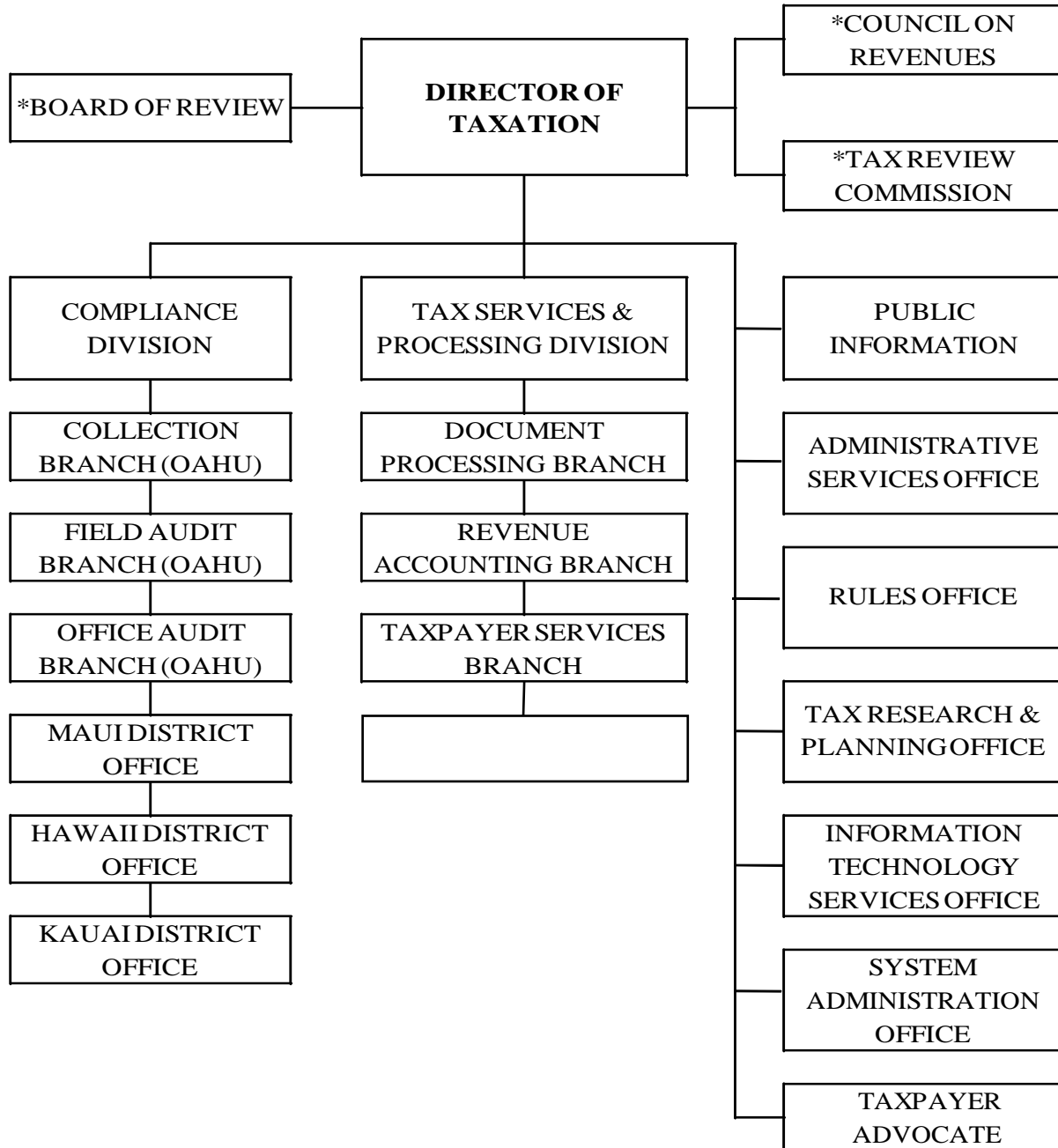
OPERATIONS STAFF

Compliance Division Chief..... Kevin Wakayama
 Tax Compliance Coordinator..... Vacant
 Oahu Field Audit Branch Chief..... Madelaina Lai
 Oahu Office Audit Branch Chief..... Donald Kuriki
 Oahu Collection Branch Chief..... William Deeley
 Maui District Tax Manager..... Kathleen Uehara
 Hawaii District Tax Manager..... Duquesne Hulihee
 Kauai District Tax Manager..... Dulcie Yano

Acting Tax Services and Processing Division Chief..... Annette Yamanuha
 Acting Taxpayer Services Branch Chief..... John Pacheco
 Acting Document Processing Branch Chief..... Donna Botelho
 Acting Revenue Accounting Branch Chief..... Lemy B. Balais

2.6 ORGANIZATION CHART

Department of Taxation
State of Hawaii



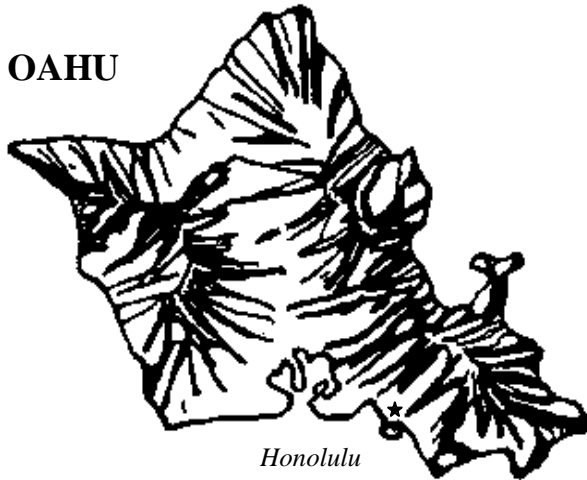
*For Administrative Purposes

2.7 DISTRICT OFFICES

FIRST TAXATION DISTRICT

City & County of Honolulu

OAHU



Honolulu

Oahu Office
830 Punchbowl Street
Honolulu, Hawaii 96813

SECOND TAXATION DISTRICT

Counties of Maui and Kalawao



Kaunakakai

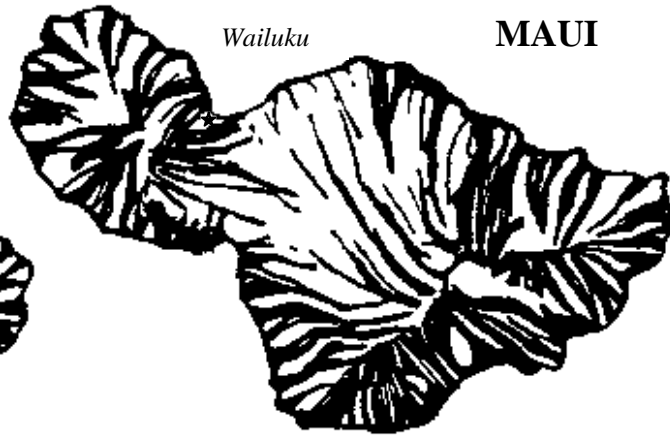
MOLOKAI

LANAI



Wailuku

MAUI



Maui Office
54 South High Street
Wailuku, Hawaii 96793

Molokai Office
35 Ala Malama Street #101
Kaunakakai, Hawaii 96748

KAHOOLAWE

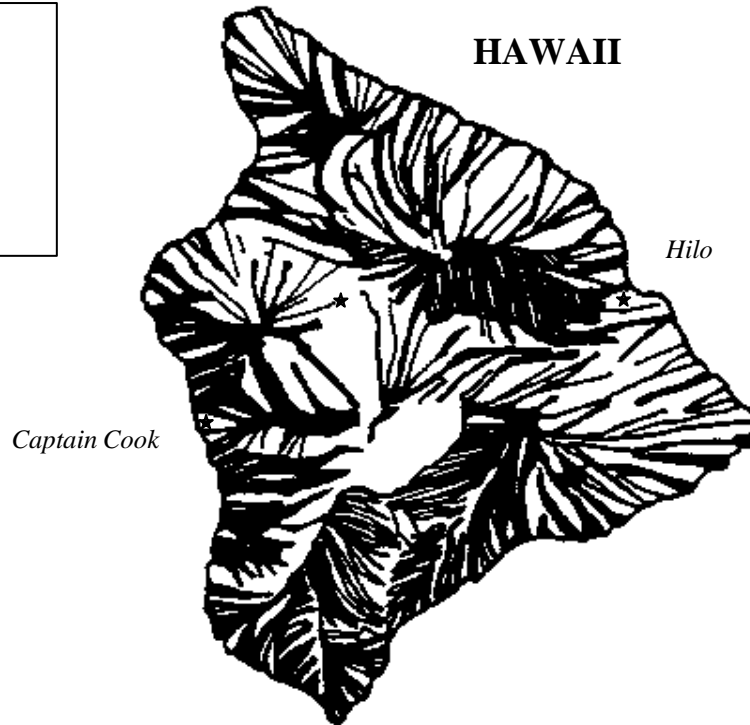


THIRD TAXATION DISTRICT

County of Hawaii

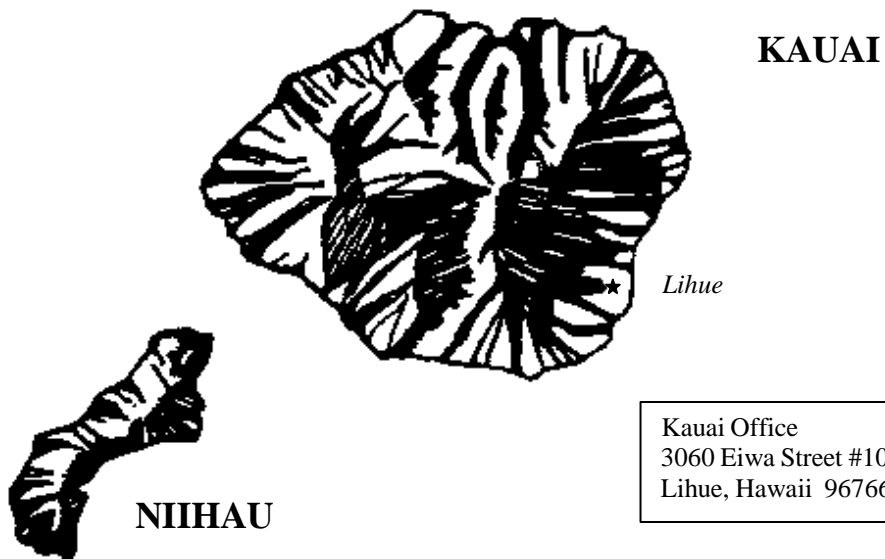
Hilo Office
75 Aupuni Street
Hilo, Hawaii 96720

Kona Office
82-6130 Mamalahoa Highway #8
Captain Cook, Hawaii 96704



FOURTH TAXATION DISTRICT

County of Kauai



Kauai Office
3060 Eiwa Street #105
Lihue, Hawaii 96766

3.0 TAX APPEALS AND LITIGATION

3.2 CIVIL DECISIONS, SETTLEMENTS AND OTHER LEGAL MATTERS

Matters Closed

During the last fiscal year, the Tax & Charities Division (“Division”) closed 688 Tax Department-related legal matters, not including legislative matters which have not yet been closed, in our case management system by the Department’s Legislative Division. This report also does not include the myriad of charitable oversight, charity registration and charitable solicitation or charitable trust related matters the Division routinely handles.

| | | |
|-------------------------------|---|-----|
| Appeals | - | 26 |
| Bankruptcies | - | 449 |
| Contracts | - | 11 |
| Foreclosures | - | 121 |
| Legislation (None closed yet) | | |
| Miscellaneous | - | 28 |
| Opinions | - | 4 |
| Quiet Title | - | 12 |
| Subpoenas | - | 37 |

Amounts Collected

Last fiscal year, the Division collected the following amounts³:

| | |
|---------------|-----------------------|
| Tax Appeals | \$119,913.49 |
| Foreclosures | \$0.00 |
| Bankruptcies | \$1,161,005.91 |
| Trusts | \$0.00 |
| Miscellaneous | \$0.00 |
| TOTAL | <u>\$1,280,919.40</u> |

3.2.1 Settled Cases

Tax Appeal Court

In the Matter of the Tax Appeals of TEAM TV, T.A. Nos. 08-0107 and 09-0046, Tax Appeal Court, State of Hawaii.

Taxpayer was denied the high technology business investment tax credit provided under § 235-110.9, HRS. The Department argued that Taxpayer had, among other things, not made an "investment" as required by § 235-110.9, HRS, to claim this credit. The parties reached an agreement in principle and are working on a closing agreement.

³The Division also secured the dismissal of several tax appeals that would have potentially resulted in refunds to taxpayers from the General Fund and won cases on appeal that will have fiscal impact on similarly situated taxpayers and result in future tax collections that are impossible to forecast.

In the Matter of the Tax Appeal of Passport Resorts, LLC, Case No. 10-0031, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed additional general excise taxes related to gross receipts for hotel management services performed for a hotel located within the state. Taxpayer claimed the services were performed out-of-state and were not taxable. The local hotel was also assessed use taxes on these same services. The parties reached an agreement in principle and are working on the closing agreement.

In the Matter of the Tax Appeal of Analytical Services Inc., Case Nos. 13-1-0258 and 13-1-0278, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed general excise taxes for 2003 through 2009, inclusive, and requested a refund that the Department denied. Taxpayer claimed that it was not subject to the general excise tax on services provided to the military because its software applications were not limited to Hawaii military users. This case was settled and the case dismissed.

In re the Tax Appeals of Larry Ordonez, Jeniffer Ordonez and Mortgage Choice, Inc., T.A. No. 13-1-0274, Tax Appeal Court, State of Hawaii.

Taxpayers appealed from general excise tax assessments for 2004 and 2005 and 2007 through 2009, inclusive totaling \$68,611.00. The parties reached a settlement and the case was dismissed on April 24, 2014.

3.2.2 Closed Cases

Tax Appeal Court

In the Matter of the Tax Appeal of Leslie-Ann Yokouchi, Case No. 10-1-1802, Tax Appeal Court, State of Hawaii.

Taxpayer was disallowed certain deductions and was assessed additional income taxes as a result. Taxpayer failed to or was unable to provide proper documentation to substantiate deductions for business expenses under audit. Taxpayer conceded the Director's assessments were correct and dismissed the appeal.

In the Matter of the Tax Appeal of Prudential Aina Maui, LLC, Case No. 10-1-1803, Tax Appeal Court, State of Hawaii.

The Department disallowed certain deductions and assessed additional income taxes as a result. Taxpayer claimed deductions for improper business expenses and was unable to provide proper documentation to substantiate deductions for other business expenses under audit. Taxpayer conceded the Director's assessments were correct and dismissed the appeal.

In the Matter of the Tax Appeal of MSY Corp., Case No. 10-1-1804, Tax Appeal Court, State of Hawaii.

The Department disallowed certain deductions and assessed additional income taxes as a result. Taxpayer failed to or was unable to provide proper documentation to substantiate deductions for business expenses under audit. Taxpayer conceded the Director's assessments were correct and dismissed the appeal.

In the Matter of the Tax Appeal of Omega & Beyond, Inc., Case No. 12-1-277; 12-1-278; 12-1-279; 12-1-280; 12-1-281; 12-1-282, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed general excise taxes for tax years 2005 and 2006 and general excise and county surcharge taxes for tax years 2007 through 2010, inclusive, for underreported services including professional income. Taxpayer claimed that the income arising out of a federal contract was exempt from general excise tax because the services were performed, used, and consumed out of state. The Court granted the Director's motion for summary judgment.

In the Matter of the Tax Appeal of Alex Ou, Case Nos. 12-1-269; 12-1-304, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed general excise, transient accommodations, and county surcharge taxes for rental income from tax years 1997 through 2010, inclusive. Taxpayer argued that his management company was obligated to pay the taxes and file the appropriate tax returns and that he was unaware that it was not doing so. Taxpayer dismissed the case.

First Circuit Court

Sierra Club v. Department of Taxation; Civil No. 12-1-3119-12 ECN, Circuit Court of the First Circuit.

Plaintiff brought suit for preliminary injunction to stop the Department from implementing temporary administrative rules clarifying the Renewable Energy Technologies Income Tax Credit prescribed in section 235-12.5, HRS. The Department's temporary rules, among other things, defined the term "system" so that taxpayers would have specific requirements to meet to qualify for the credit. The Department prevailed and the motion was denied.

Intermediate Court of Appeals

In the Matter of the Tax Appeal of Bobby R. Narmore, T.A. No. 02-0065, Tax Appeal Court, State of Hawaii.

After a trial, the Tax Appeal Court determined that the Department's general excise tax assessment for tax year 1992 was proper. The Tax Appeal Court found that Taxpayer did not file a general excise tax return to start the statute of limitations and as a result of this finding, the court determined that the Department properly issued the assessment. The Intermediate Court of Appeals affirmed the decision of the Tax Appeal Court and the Hawaii Supreme Court refused to grant certiorari.

3.2.3 Pending Appeals

Hawaii Supreme Court

In the Matter of the Travelocity.Com, LLC, Case No. 11-1-0020, Tax Appeal Court, State of Hawaii (Consolidated Cases).

Travelocity.com LP, Site 59.com LLC, Expedia, Inc., Hotwire, Inc., Hotels.com,

L.P., Orbitz, LLC, Internetwork Publishing Corp. (d/b/a Lodging.com), Trip Network, Inc. (d/b/a CheapTickets.com), priceline.com Inc., and Travelweb LLC filed separate Notices of Appeal to the Tax Appeal Court of the State of Hawaii, timely appealing final notices of assessments of general excise tax and transient accommodations tax for the period 1999 through 2011, inclusive. By orders filed on February 8, 2012 the Tax Appeal Court granted the Department's motions for summary judgment on the general excise tax assessments and denied the Department's assessments of transient accommodations taxes. On August 15, 2013, the Tax Appeal Court entered a final judgment in favor of the State on the general excise tax assessments and against the State on the transient accommodations tax assessments. The amount of general excise tax, penalties and interest owed as of the date of the final judgment was \$246.8 million. The Hawaii Supreme Court granted the parties petition to transfer the appeal directly to the Hawaii Supreme Court. The case is fully briefed and the Court has scheduled oral arguments for October 2, 2014.

Tax Appeal Court

In the Matter of the Tax Appeal of One Napili Way Interval Owners Association, T.A. No. 09-0069, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed additional general excise taxes for amounts it received for condominium maintenance fees that it collected on behalf of its members and paid to the One Napili Way AOA. Taxpayer asserted the fees it collected were not income for purposes of chapter 237, HRS, and, alternatively, that the amounts were exempt reimbursements under § 237-20, HRS. Trial is set for December 8, 2014.

In the Matter of the Tax Appeals of TMI Management, Inc., T.A. Nos. 09-0071 and 09-0072, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed additional general excise taxes on amounts received for performing work for the federal government. Taxpayer argued, among other things, that the disputed income was exempt because Taxpayer was an employee leasing company and the disputed income was for salaries and expenses of leased employees. This case has been taken off the calendar to give the parties time to work on settlement.

In the Matter of the Tax Appeals of Bernard & Ellen Fuller and South Pacific Builders, Ltd., T.A. Nos. 09-0087, 09-0088 and 09-0089, Tax Appeal Court, State of Hawaii.

Taxpayers were assessed additional general excise and net income taxes on amounts received for performing work within the state. Taxpayers argued, among other things, that the disputed income was exempt because Taxpayers paid certain amounts to other contractors. Trial is set for July 6, 2015.

In re Tax Appeal of CCHH Maui LLC, Case No. 09-0084 and In re Tax Appeal of CCFH Maui LLC, Case No. 09-0090, Tax Appeal Court, State of Hawaii.

Taxpayers appealed general excise tax assessments that disallowed the sublease deduction pursuant to § 237-16.5, HRS and the imposition and adjustment of use and general excise taxes. The Tax Appeal Court determined that hotel guests were not leasing real property and that Taxpayers could not claim the sublease deduction

on amounts related to hotel guest stays. The remaining legal issues in the tax appeal concern the dollar amount related to hotel guest stays, use tax, and transient accommodation taxes.

In the Matter of the Tax Appeal of CBIP, Inc., Case No. 09-0203, Tax Appeal Court, State of Hawaii.

Taxpayer appealed general excise tax assessments. The parties filed a stipulation for partial dismissal of the case. In the appeal that remains, Taxpayer argues that: (1) the assessment erroneously included general excise tax on amounts that were not gross income but, rather, were rebates of expenses; (2) penalties were erroneous because non-filing and/or underpayment was not due to negligence or intentional disregard of rules; and (3) the assessments violated the due process, commerce and/or equal protection clauses of the United States Constitution. Trial is set for October 20, 2014.

In the Matter of Tax Appeal of James J. Richard & Rachael D. Richard, Case No. 1 TX 10-1-1805, Tax Appeal Court, State of Hawaii.

Taxpayers were assessed additional income and general excise taxes. Taxpayers challenged the Department's reclassification and recalculation of its liability that was based on Taxpayers' IRC Section 338(g) election on a sale of a business. The basis of Taxpayers' claim was that they made an election error on the Form 8023 and the parties to the sale intended a Section 338(h)(10) election instead of the 338(g) election. Taxpayers also challenged the Department's reclassification of income that changed the amount received as personal loans and/or advances from their business to wages.

In the Matter of Tax Appeal of James & Associates CPAS, Inc., Case No. 1 TX 10-1-001806, Tax Appeal Court, State of Hawaii.

Taxpayer challenged the Department's reclassification and recalculation of its tax liability that was based on Taxpayer's IRC Section 338(g) election of a sale of a business. The basis of Taxpayer's claim was that it made an election error on the Form 8023 and the parties to the sale intended a Section 338(h)(10) election instead of the Section 338(g) election.

In the Matter of Tax Appeal of James Professional Services, Inc., Case No. 1 TX 10-1-001807, Tax Appeal Court, State of Hawaii.

Taxpayer challenged the Department's reclassification and recalculation of its liability that was based on Taxpayer's IRC Section 338(g) election on a sale of a business. The basis of Taxpayer's claim was that it made an election error on the Form 8023 and the parties to the sale intended a Section 338(h)(10) election instead of the Section 338(g) election. Taxpayer also challenged the use tax assessments on property it purchased.

In the Matter of the Tax Appeal of JN Group, Inc., Case No. 10-1808, Tax Appeal Court, State of Hawaii

Taxpayer appealed general excise assessments for tax years ending March 31, 1998 through March 31, 2006, inclusive. Taxpayer claimed that the amounts assessed constituted reimbursements that were exempt under sec. 237-20, HRS; the

assessments of penalties were erroneous because any non-filing or underpayment was not due to negligence or intentional disregard of rules; the assessments violated the due process, commerce, and/or equal protection clauses of the United States Constitution and the Constitution of the State of Hawaii. Trial is set for February 9, 2015.

In the Matter of the Tax Appeal of Patrick O' Brien, Case No. 11-1-0013, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed additional income taxes for unreported schedule C income from a single member LLC owned by Taxpayer. Taxpayer denied the income is taxable to him. Taxpayer's counsel has withdrawn from this case and Taxpayer is seeking new counsel. Trial is set for July 6, 2015.

In the Matter of the Tax Appeal of Security Resources, LLC, Case No. 11-1-0014; Tax Appeal Court, State of Hawaii.

Taxpayer was assessed additional general excise taxes for underreporting the amount of gross receipts it received. Taxpayer claims the assessments are overstated and that it is entitled to be taxed at the wholesale rate of .5 percent. Taxpayer also claims some of its sales are exempt because they were sales of tangible personal property to the federal government. Taxpayer's counsel has withdrawn from this case and Taxpayer is seeking new counsel. Trial is set for July 6, 2015.

In the Matter of the Tax Appeal of Helicopter Consultants of Maui, LLC, Case No. 11-1-0018; Tax Appeal Court, State of Hawaii.

The Taxpayer filed an amended general excise/use tax return for taxable year 2006 claiming a refund for use taxes paid for the importation and use of materials, parts, or tools imported for aircraft service and maintenance. The Director denied the claim for refund because Taxpayer is subject to the use tax on its imported goods and does not qualify for any of the applicable exemptions, including the exemption provided in sec. 238-1, HRS for "the use of materials, parts, or tools imported or purchased by a person licensed under chapter 237 which are used for aircraft service and maintenance, or the construction of an aircraft service and maintenance facility as those terms are defined in section 237-24.9." The Director prevailed on a partial motion for summary judgment and the parties will stipulate to dismiss the remaining issues. Trial is set for September 15, 2014.

In the Matter of Taxpayer Appeal of Stephen A. Cipres, Case Nos. 11-1-0084, 12-1-0436, 12-1-0437, Tax Appeal Court, State of Hawaii.

Taxpayer challenged the Department's general excise tax assessments on the basis that the Department incorrectly increased his commissions for certain years and misinterpreted and misapplied the penalty provisions in the HRS. Trial is set for October 27, 2014.

In the Matter of the Tax Appeal of Jesse Spencer and Joyce Spencer, 1 T.X. Case No. 11-1-0098, Tax Appeal Court, State of Hawaii.

Taxpayers appealed income tax assessments for tax years 2005, 2006, and 2007. Taxpayers claimed that the assessments improperly denied their carryover

residential construction and remodeling tax credit under sec. 235-110.45, HRS, and their pass-through capital goods excise tax credit. Taxpayers also claimed that they were not required under sec. 235-110.45, HRS, to attach Form N-332 to their 2005 and 2006 Form N-11s to claim properly and timely the tax credit for those years. They further claimed that the assessments and the decision of the board of review violated Hawaii law, due process, the commerce and/or equal protection clauses of the United States constitution and the Constitutions of the State of Hawaii and the State of Hawaii and the Department of Taxation Taxpayer's Bill of Rights. Trial is set for February 16, 2015.

In the Matter of the Tax Appeal of Ronald Au, T.A. No. 11-1-0144, Tax Appeal Court, State of Hawaii.

Taxpayer filed a petition to compel the Board of Review to prepare findings of fact and conclusions of law. The court denied the petition but granted leave to the taxpayer to file a notice of appeal from general excise tax assessments for the period 2002 through 2005, inclusive, totaling \$175,000.00. The Tax Appeal Court granted the Department of Taxation's motion to dismiss the appeal for lack of subject matter jurisdiction by order filed February 29, 2012; however, the Court granted Taxpayer's motion for reconsideration of the dismissal. The Court has taken a motion for summary judgment under advisement. No trial date has been set.

In the Matter of the Tax Appeal of Kama'aina's Food Service, Inc., Case Nos. 12-1-0237 and 12-1-0244, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed for general excise tax and county surcharge when applicable, for unreported services income for tax years 1987 through 1992, 1994, 1995, 1997, 1998, and 2000 through 2009 and/or imposed a 25 percent penalty for failure to file and a 25 percent penalty due to negligence or intentional disregard of rules. Taxpayer was assessed for general excise tax for unreported services income for tax years 1993, 1996, and 1999; The Department imposed a 25 percent penalty for failure to file and a 25 percent penalty due to negligence or intentional disregard of rules. Taxpayer disputes the assessments, arguing that the imposition of both penalties is not authorized by statute. Trial is set for March 30, 2015.

In the Matter of the Tax Appeal of CompUSA Inc., T.A. Nos. 12-1-0264, 12-1-0265, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the disallowance of a use tax refund request for use taxes paid for 2006, 2007, and 2008. Taxpayer is arguing that under the commerce clause and equal protection clauses of the United States Constitution the imposition of Hawaii's use tax is unconstitutional. Motions for Summary Judgment are under advisement.

In the Matter of the Tax Appeal of JTSI, Inc., Case No. 1TX-12-1-0276, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed general excise and county surcharge taxes on sales of services to government instrumentalities. Taxpayer argues that it primarily sold tangible personal property to the federal government that is exempt from general excise taxes. Trial is set for September 28, 2015.

In the Matter of the Tax Appeal of Barbara Gilliss, Case No. 12-1-0303, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed general excise and county surcharge taxes, when applicable, for rental income in tax years 2002 through 2011, inclusive. Taxpayer argues that the penalties and interest should be waived. Trial is set for November 3, 2014.

In the Matter of the Tax Appeal of Safeway Inc., Case No. 12-1-0385, Tax Appeal Court, State of Hawaii.

Taxpayer's claim for refund of use taxes was denied. Taxpayer argues that it should not have paid use taxes on amounts paid to a licensed shipper. The Department asserts use tax is calculated on the landed value of the imported items, including shipping. Trial is set for December 1, 2014.

In the Matter of the Tax Appeal of Julie A. Dunham, Case No. 12-1-0390, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed general excise and income taxes on non-filed returns for 1999 through 2010, inclusive. Taxpayer argues that the Department's income figures are incorrect. Trial is set for September 14, 2015.

In the Matter of the Tax Appeal of Ronald Au, Case No. 1TX 12-1-0393, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing the Department's income tax assessments on unreported income received for tax years 2008 and 2009. Trial is set for July 27, 2015.

In the Matter of the Tax Appeal of Zephyr Insurance Company, Inc., Case Nos. 1TX 13-1-0223, 1TX 13-1-0227, 1TX 13-0229, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing the Insurance Commissioner's tax assessment that disallowed its claim to the Qualified High Technology Business ("QHTB") tax credit pursuant to §235-110.9, HRS. The disallowance was based on the Department determination letter to the Insurance Commissioner that ruled that Taxpayer was not entitled to claim the QHTB. Trial is set for October 26, 2015.

In the Matter of the Tax Appeal of William A. Bartenstein, Case No. 13-1-0228, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed additional general excise and/or use taxes, penalties and interest on goods imported for resale. Taxpayer argues that the Department's income figures are incorrect and the stacking of the negligence and underpayment penalties is erroneous. Trial is set for September 29, 2014.

In the Matter of the Tax Appeal of Peter Whiting, Case Nos. 1TX 1-13-0232, 1TX 1-13-0233, 1TX 1-13-0234, 1TX 1-13-0235, 1TX 1-13-0236, 1TX 1-13-0237, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing the Department's general excise tax assessments on unreported income received from his personal business tax years 2004, 2005, 2006, 2008, 2009, 2010, and 2011. Taxpayer did not file any general excise tax returns for these years. Trial is not set.

In the Matter of the Tax Appeal of Peter Whiting and Shanna Whiting, Case Nos. 1TX 1-13-0238, 1TX 1-13-0239, 1TX 1-13-0240, 1TX 1-13-0241, 1TX 1-13-0242, 1TX 1-13-0243, 1TX 1-13-0244, 1TX 1-13-0245, 1TX 1-13-0246, 1TX 1-13-0247, 1TX 1-13-0248, 1TX 1-13-0249, 1TX 1-13-0250, 1TX 1-13-0251, 1TX 1-13-0252, 1TX 1-13-0253, Tax Appeal Court, State of Hawaii.

Taxpayers are appealing the Department's general excise and transient accommodations tax assessments on unreported rental income received for tax years 2004, 2005, 2006, 2008, 2009, 2010, and 2011. Taxpayers did not file any general excise or transient accommodations tax returns for these years. Trial is not set.

In the Matter of the Tax Appeal of Kauai Development LLC, Case No. 13-1-0255, Tax Appeal Court, State of Hawaii.

Taxpayer was assessed general excise on imputed interest. Taxpayer argues that the statute of limitations has run and that general excise taxes are not applicable to imputed interest. Trial has been set for January 12, 2015.

Trip Network, Inc. v. State of Hawaii, Case No. 13-1-0261, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Orbitz, LLC v. State of Hawaii, Case No. 13-1-000262, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Internetwork Publishing Co. v. State of Hawaii, Case No. 13-1-000263, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Travelweb, LLC v. State of Hawaii, Case No. 13-1-000264, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Expedia, Inc. v. State of Hawaii, Case No. 13-1-000265, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Hotwire, Inc. v. State of Hawaii, Case No. 13-1-000266, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Hotels.com LLP v. State of Hawaii, Case No. 13-1-000267, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Site59.com v. State of Hawaii, Case No. 13-1-000268, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Priceline.com, Incorporated v. State of Hawaii, Case No. 13-1-000269, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

Travelocity.com LLP v. State of Hawaii, Case No. 13-1-000270, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing from the assessment of general excise and transient accommodations taxes for tax year 2012 resulting from the online sale of hotel rooms via Taxpayer's Internet site. Trial is not set.

In the Matter of Charles A. Shipman, Jr., Case No. 1TX 13-1-000301, Tax Appeal Court, State of Hawaii.

Taxpayer is appealing his tax assessment for general excise and transient accommodation taxes, stating the assessed amounts were speculative/inflated and included improper stacking of failure to file penalties with negligence penalties. Trial is not set.

In the Matter of the Tax Appeal of H. Graham Wood and Charlene L. Asato, Case No. 1-TX.-13-1-0304, Tax Appeal Court, State of Hawaii.

Taxpayers appealed from the assessment of net income taxes on pension income from 2009. The Department assessed Taxpayers for unsubstantiated sources of pension income. Trial is set for April 25, 2015.

In the Matter of the Tax Appeal of Ronald Au, T.A. No. 14-1-026, Tax Appeal Court, State of Hawaii.

Taxpayer filed a notice of appeal from a Board of Review decision in favor of the Department in the amount of \$13,144.62 for general excise taxes, penalties and interest for tax years 2009 and 2010. On March 17, 2014, the Tax Appeal Court

heard the Department of Taxation's motion to dismiss this case for lack of subject matter jurisdiction. The motion remains under advisement.

In the Matter of the Tax Appeal of Skydiving School, Inc., Case No. 1TX 14-1-0217 and 1TX 14-1-0218, Tax Appeal Court, State of Hawaii.

Taxpayers appealed from the denial of a refund claim and assessments of general excise taxes related to its skydiving business. Taxpayer's major issue is that its gross receipts from skydiving activities is not subject to the general excise tax because of preemption by the Anti-Head Tax Act, P.L. 103-272, 108 Stat. 1111, as amended, and as codified in 49 U.S.C. § 0116. Trial is not set.

In the Matter of the Tax Appeal of Hawaiian Telcom Services Company, Inc., Case No. 1 TX 14-1-0231, Tax Appeal Court, State of Hawaii.

Taxpayer appeals the denial of use tax refund claims. Taxpayer claims that sections 238-2 and 238-2.3, HRS, impermissibly imposes use tax in violation of the Commerce Clause and the Equal Protection Clause of the United States Constitution; the statutes discriminate against interstate commerce and are not fairly apportioned; and that Taxpayer erroneously paid use taxes with respect to services and/or contracting performed within the State by a licensed seller. Trial is not set.

In the Matter of the Tax Appeal of Hawaiian Telcom, Inc., Case No. 1 TX 14-1-0232, Tax Appeal Court, State of Hawaii.

Taxpayer appeals the denial of use tax refund claims. Taxpayer claims that sections 238-2 and 238-2.3, HRS, impermissibly imposes use tax in violation of the Commerce Clause and the Equal Protection Clause of the United States Constitution; the statutes discriminate against interstate commerce and are not fairly apportioned; and that Taxpayer erroneously paid use taxes with respect to services and/or contracting performed within the State by a licensed seller. Trial is not set.

In the Matter of the Tax Appeal of Hawaiian Electric Company, Inc., Case No. 1 TX 14-1-0233, Tax Appeal Court, State of Hawaii.

Taxpayer appeals the denial of use tax refund claims. Taxpayer claims that sections 238-2 and 238-2.3, HRS, impermissibly imposes use tax in violation of the Commerce Clause and the Equal Protection Clause of the United States Constitution and that the statutes discriminate against interstate commerce and are not fairly apportioned. Trial is not set.

In the Matter of the Tax Appeal of Edward A. Alquero, M.D., Inc., Case No. 1 T.X. 14-1-0219, Tax Appeal Court State of Hawaii.

Taxpayer was assessed additional income and general excise taxes, penalties, and interest for underreported income related to his medical practice. Taxpayer is claiming he is entitled to deductions for certain expenses that were disallowed by the Department. Trial has been set for January 18, 2016.

In the Matter of the Tax Appeal of Ronnie D. Diaz and Imelda B. Diaz, Case No. 1 TX 14-1-0220, Tax Appeal Court, State of Hawaii.

Taxpayers are appealing tax assessments of the county surcharge on their janitorial services. Trial is not set.

In the Matter of the Tax Appeal of BAE Systems Technical Services, Inc., Case No. 1 T.X. 14-1-0224, Tax Appeal Court State of Hawaii.

Taxpayer was denied a general excise tax exemption for amounts received for scientific work performed under contract with the United States. Taxpayer is relying on statements made by the auditor that they qualify for the exemption. Trial has been set for July 13, 2015.

In the Matter of the Tax Appeal of Avery B. Chumbley, Case No. 1 T.X. 14-1-0226, Tax Appeal Court State of Hawaii.

Taxpayer was assessed general excise taxes and interest for underreported gross receipts of a non-profit organization's fund raising activities. Taxpayer was assessed personally as the president of the organization at the time. Taxpayer is claiming he is entitled to deductions for certain expenses that were disallowed by the Department. Trial has been set for June 22, 2015.

In the Matter of the Tax Appeal of Darren Truitt, Case No. 1 T.X. 14-1-0228, Tax Appeal Court State of Hawaii.

Taxpayer was assessed additional income taxes, penalties, and interest for income attributed to his wholly owned LLC. Trial has been set for August 10, 2015.

In the Matter of the Tax Appeal of Construction Services & Management LLC, Case No. 1 T.X. 14-1-0229, Tax Appeal Court State of Hawaii.

Taxpayer was assessed general excise taxes, penalties, and interest for underreported gross receipts. Trial has been set for August 10, 2015.

In the Matter of the Tax Appeal of BAE Systems Holdings, Inc. & Subs.; Case No. 1 T.X. 14-1-0234, Tax Appeal Court State of Hawaii.

Taxpayer claims for the High Tech Credit provided under section 235-110. , HRS, were denied because the Taxpayer did not make an investment as defined by statute. The Taxpayer prevailed at the Board of Review and the Department filed this appeal. Trial is not set.

3.2.4 Criminal Investigations/Enforcement Actions

Cases Worthy of Note:

A local businessman who is the owner of two different corporations was charged with sixteen counts of failing to file general excise, withholding, and corporate income tax returns for both of his businesses. Taxpayer pled guilty to all charges and was placed on probation for a year, ordered to perform 75 hours of community service work, and pay restitution in the amount of \$618,516.00 jointly and severally with each company.

One of those businesses was a trucking company that failed to report more than \$18 million dollars in gross income it received and did not pay \$520,753 in taxes due. A construction company also owned by the same taxpayer was charged in a separate case because it failed to report nearly \$3 million dollars it received in gross income and failed to pay \$97,763 in taxes due. Each company was charged with eight counts of failing to file its tax returns for tax years 2006 through 2008, inclusive and both were fined \$800.

A Honolulu Real Estate Sales Associate failed to report over \$146,600 she received in commission income and was charged with six counts of failing to file her general excise and individual income tax returns for tax years 2006 through 2008, inclusive. In addition to the misdemeanor violations, she was also charged with one count of Attempt to Evade or Defeat tax which is a violation of § 231-3, HRS and a felony. The taxpayer attempted to hide monetary assets to evade payment of her general excise and individual net income taxes that were previously assessed against her by the Department.

Pursuant to a plea agreement reached with the Attorney General's Office, Taxpayer pled guilty to all charges and paid full restitution for the misdemeanor taxes prior to sentencing. Taxpayer also agreed to pay restitution of \$107,141 for the one felony charge and a fine of \$9,000. The court granted her request for a deferral of her guilty plea and placed her on probation for a period of five years and ordered her to remain tax compliant throughout her period of probation.

An unlicensed contractor who in past years was charged and convicted in two separate criminal tax cases was legally deported for violating federal immigration laws. Taxpayer who built rock walls for a living did so without a valid contractor's license and had numerous complaints filed against him with the Regulated Industries Complaints Office of the Department of Commerce and Consumer Affairs. Taxpayer repeatedly entered into construction contracts with home owners and got money advanced to him to begin the projects. He did little or no work in each case and walked away with the monies he received from the home owners. Taxpayer was originally charged in 2005 with three misdemeanor counts of failing to file his general excise tax returns and served a sixty-day prison term. In 2011 he was charged with four counts of false and fraudulent statements which are felony violations and was found guilty of the charges. The judge decided the defendant had increased the severity of his crimes and showed no remorse for his actions. Taxpayer was ordered to serve a year in prison and was placed on probation for a period of five years upon his release.

Taxpayer, who was not a naturalized United States citizen, unknowingly violated federal immigration laws by having a criminal record that included four felony convictions. The United States Bureau of Immigration and Customs Enforcement reviewed his criminal record and determined there were violations. The agency revoked his visa and officially deported Taxpayer back to his native Tonga on July 10, 2013. This is the only criminal tax case in the Department's history in which a federal government agency used its enforcement powers against an individual for violating Hawaii tax laws.

Despite the amount of complaints and indictments this fiscal year, the Criminal Investigations Section (CIS) continues to receive numerous referrals and reports of potential cases from both internal and external sources. CIS is a critical part of the

Department of Taxation and should continue with its efforts of deterrence through the successful prosecution of tax offenders. Steady media exposure can also encourage better tax compliance and helps to fulfill the Department's mission of administering the tax laws of the State of Hawaii in a consistent, uniform, and fair manner.

ADMINISTRATIVELY ATTACHED ENTITIES

As of June 30, 2014

COUNCIL ON REVENUES

Kurt Kawafuchi, Chair
Marilyn M. Niwao, Vice-Chair
Carl S. Bonham
Christopher Grandy
Elizabeth P. Cambra
Jack P. Suyderhoud
Kristi L. Maynard

BOARDS OF TAXATION REVIEW

FIRST TAXATION DISTRICT

(Oahu)
Audrey Abe
Tracy T. Chiang
Curtis Saiki
Alan Mun Leong Yee
Eric Ching

SECOND TAXATION DISTRICT

(MAUI)
Randal Taniguchi
Michele A. Kato
Faye M. Murayama
Vacant
Vacant

THIRD TAXATION DISTRICT

(HAWAII)
Michael Chang
Peter M. Tadaki
Vacant
Vacant
Vacant

FOURTH TAXATION DISTRICT

(KAUAI)
Jose R.S. Diogo
Russell Kyono
Albert Spencer
Eric N. Yama
Vacant