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March 6, 2002

TAX INFORMATION RELEASE NO. 2002-1

RE: Audit of Net Income, General Excise, and Use Tax Returns; Appeal Rights; Claims for Refund; and Payment to State under Protest

This Tax Information Release ("TIR") supersedes TIR No. 94-3, dated May 24, 1994.¹ This TIR summarizes statutory rights, obligations, and procedures, relating to the audit of net income, general excise, and use tax returns by the Department of Taxation ("Department") which may result in the assessment of additional taxes; appeals from the assessment of taxes; claims for refund or credit; and payment to the State under protest. The Department advises all taxpayers to review the Hawaii Revised Statutes (HRS) and Hawaii Administrative Rules or to consult with their tax advisor as this TIR is issued solely as a guide and is not intended to be complete.

I. AUDIT OF TAX RETURNS

Under the state tax system of self-assessment, taxpayers determine their tax liability by filing a tax return and remitting the taxes due to the Department. To ensure the highest degree of voluntary compliance, the Department is authorized to audit any tax return filed. An audit may result in a determination that additional taxes are due, including interest and penalties.

Tax returns are selected for audit based upon various methods, including the following. First, tax returns may be audited based on information that the Department receives from the Internal Revenue Service. Second, returns may be selected randomly. Third, returns may be selected by such methods as examining claims for credit or refund of previously paid taxes and matching information documents.

If a taxpayer's return is selected for audit, the audit may be conducted by correspondence, at the taxpayer's home, place of business, at the Department or at the office of the taxpayer's attorney or accountant. A taxpayer may represent himself or herself or may be accompanied or represented by another person.

¹ Section II of the TIR is amended to reflect amendments by Act 199, Session Laws of Hawaii 2000 which eliminated the requirement to pre-pay the tax (including penalty and interest) assessed as a condition to appealing to one of the four Boards of Review. The pre-payment requirement is still in effect for direct appeals to the Tax Appeal Court.

It is the auditor's duty to determine the taxpayer's correct tax liability. This may be accomplished by an examination of the taxpayer's books and records and by interviewing witnesses. Sections 235-102, 237-41, and 238-9, HRS, require taxpayers to keep books of accounts or records sufficient to establish the amount of gross income, deductions, credits, or other matters required to be shown in any return, generally for three years. Taxpayers who fail to keep those records may be subject to a fine or criminal penalty under section 231-35,

HRS.² Section 231-7, HRS, authorizes the issuance of subpoenas to take testimony of the person summoned and to request and examine books and records.

There are statutes of limitations for periods in which the Department must assess the tax, generally within three years after the return is filed or the due date of the return, whichever is later. The statute of limitations, does not run, however, if the return filed is false, fraudulent, if no return is filed, or if there is an agreement in writing between the Department and the taxpayer to extend the statute of limitations. Sometimes the Department cannot complete an audit prior to the expiration of the statutory period. If that happens, the Department and the taxpayer, prior to the expiration of the statute of limitations, may agree to extend the period for assessment of the tax.

When the audit is completed, the auditor may propose no changes to the taxpayer's tax liability shown on the tax return. Therefore, the return is accepted as filed.

On the other hand, the auditor may propose adjustments to the taxpayer's tax liability by sending the taxpayer a notice of proposed assessment of additional taxes. If the taxpayer disagrees with the proposed assessment, the taxpayer has thirty days from the date of the proposed assessment to confer with the auditor about the proposed assessment. The taxpayer may submit additional evidence or information for consideration by the auditor or request a discussion with the auditor or the auditor's supervisor regarding the proposed adjustments.

If the taxpayer and the auditor are unable to agree on the proposed assessment or the taxpayer does not respond to the notice of proposed assessment, a notice of assessment of additional taxes is mailed to the taxpayer at the taxpayer's last known address or place of business. The tax, interest, and penalty, if any, are due within twenty days after the date the notice was mailed. If the taxpayer does not intend to contest the assessment, the taxpayer should pay the assessment within twenty days of the date of the notice of assessment to stop the further accrual of interest.

Notwithstanding the foregoing, section 231-24, HRS, authorizes the Department to make a jeopardy assessment. The Department may immediately assess and demand the taxes if the Department determines that a taxpayer may depart quickly from Hawaii or may remove the taxpayer's property which would prejudice collection of the taxes.

² Any person who willfully fails to make a return, report, keep records, supply information, or secure a license as required by law, shall be guilty of a misdemeanor and upon conviction be subject to one or any combination of the following: (1) a fine of not more than \$25,000; (2) imprisonment of not more than one year; or (3) probation; provided that a corporation shall not be fined more than \$100,000.

If the taxpayer disagrees with the assessment of additional taxes, the taxpayer may file an appeal.

II. APPEAL

A taxpayer may file an appeal of the assessment of additional taxes to the board of review or tax appeal court, as provided by chapter 232, HRS, within thirty days of the date when the notice of assessment was mailed. There is a board of review for each of the four

taxation districts. Each board consists of five members appointed by the Governor to informally hear appeals. The tax appeal court is run by a judge of the first circuit court assigned to hear tax appeals.

A. Appeal to the Board of Review

An appeal to the board of review may be filed with the respective board for the taxation district in which the taxpayer has the taxpayer's principal place of business, with the board for the district in which the taxpayer resides or has the taxpayer's principal office, or with the board for the first taxation district. An appeal to the board of review is timely if the notice is deposited in the mail, postage prepaid, properly addressed to the tax assessor, within thirty days of the date when the notice of assessment was mailed. The board will notify the taxpayer of the time and date of the hearing. The taxpayer may be accompanied or represented by the taxpayer's accountant or attorney in the hearing before the board. The board's decision may be appealed to the tax appeal court by filing a written notice of appeal in the tax appeal court within thirty days after the filing of the decision of the board. If the taxpayer prevails at the board of review level and the Department appeals, the taxpayer is not required to pay the tax assessed. However, the tax assessed must be paid when the decision by the board is in favor of the Department and is appealed by the taxpayer.

A taxpayer appealing an assessment to the board of review is not required to pay the tax (including penalties and interest) under sections 235-114 (income tax), 237-42 (general excise tax), and 238-8 (use tax), HRS. The requirement to pay the tax assessed is still in force for direct appeals to the tax appeal court and an appeal by a taxpayer of a decision by the board that is adverse to the taxpayer.

B. Appeal to the Tax Appeal Court

A taxpayer contesting the assessment of taxes may appeal directly to the tax appeal court without first appealing to the board of review by filing a written notice of appeal in the office of the clerk of the tax appeal court within thirty days of the date when the notice of assessment was mailed and by delivering a copy of the notice of appeal to the tax assessor. The assessment must be paid on a direct appeal to the tax appeal court. Sections 237-42 and 238-8, HRS, respectively, require that the assessment be paid when a general excise or use tax assessment is appealed. Section 235-114, HRS, requires that the assessment be paid when an income tax assessment is appealed, except in the case of an individual taxpayer with an income tax liability of \$50,000 or less in the aggregate and a showing that payment of the tax before the appeal would result in irreparable harm to the individual taxpayer.

Since this is a court proceeding, the taxpayer may be represented by a licensed attorney or the taxpayer may represent himself or herself. A taxpayer also may take advantage of the tax appeal court's small claims procedure if the total tax liability, excluding penalties and interest, is less than \$1,000; a \$3.00 filing fee is paid; and a written statement of facts and a waiver of the right to appeal to the supreme court is filed. The taxpayer may represent himself or herself in the small claims proceeding.

A decision of the tax appeal court, except decisions under the small claims procedure, may be appealed to the Hawaii supreme court within thirty days after the court's decision is filed.

III. CLAIMS FOR REFUNDS

If an appeal is not filed with the board of review or the tax appeal court within thirty days of the date when the notice of assessment was mailed, the taxpayer must pay the assessment. If a taxpayer instead requests a credit or refund by filing an amended return after an assessment is made, the Department will deny the credit or refund as there is nothing in the statute authorizing the credit or refund under those circumstances. The Department also will not issue a credit or refund if the taxpayer files an appeal from an assessment.

When a taxpayer fails to appeal an adverse decision of the board of review or the tax appeal court, the decision of the board or the tax appeal court is final.

Section 235-111(b), HRS, specifies the limitation period for the filing of refund or credit claims for income taxes. The claim for a credit or refund shall be filed by the taxpayer or employer within three years from the time the return was filed or from the due date prescribed for the filing of the return, or within two years from the time the tax was paid, whichever is later.³ Taxes paid before the due date of the return shall be deemed to have been paid on the due date of the return determined without regard to any extensions.

- (1) If the claim was filed by the taxpayer during the three-year period, the amount of the credit or refund shall not exceed the portion of the tax paid within the period, immediately preceding the filing of the claim, equal to three years plus the period of any extension of time for filing the return.
- (2) If the claim was not filed within the three-year period, the amount of the credit or refund shall not exceed the portion of the tax paid during the two years immediately preceding the filing of the claim.

³ Section 235-2.45(k), HRS, makes operative Internal Revenue Code section 6511(h), relating to the suspension of the running of the limitation period while the taxpayer is unable to manage their financial affairs due to disability.

Section 235-101(b), HRS, extends the limitation period for a refund of State income taxes for a period of one year from the date the Department is notified by the Internal Revenue Service of a change, correction, adjustment or recomputation of the taxable income reported on the taxpayer's federal income tax return.

- (3) If no claim was filed, the credit or refund shall not exceed the amount which would be allowable under paragraph (1) or (2), as the case may be, if the claim was filed on the date the credit or refund is allowed.

Similarly, section 237-40(d), HRS, bars refund or credit claims for general excise and use taxes unless the claim is filed as follows:

- (1) If an annual return is timely filed, or is filed within three years after the date prescribed for filing the annual return, then the credit or refund shall be claimed within three years after the date the annual return was filed or the date prescribed for filing the annual return, whichever is later.
- (2) If an annual return is not filed, or is filed more than three years after the date prescribed for filing the annual return, a claim for credit or refund shall be filed within:
 - (A) Three years after the payment of the tax; or
 - (B) Three years after the date prescribed for the filing of the annual return, whichever is later.

Paragraphs (1) and (2) are mutually exclusive. The limitation shall not apply to a credit or refund pursuant to an appeal provided for by section 237-42, HRS.

A separate return must be filed for each tax year involved, together with an explanation of each item of income, deduction, or credit which is the basis for the credit or refund. As in the case of audited returns, the claim may be accepted as filed or may be subject to examination and audit.

IV. PAYMENT OF TAXES UNDER PROTEST

In lieu of filing an appeal or if an appeal is not filed with the board of review or tax appeal court within thirty days of the date when the notice of assessment was mailed, section 40-35, HRS, allows the taxpayer to pay under protest disputed portions of the assessment. A taxpayer may recover those taxes paid under protest if an action for recovery is commenced in the tax appeal court within thirty days from the date of the payment and the taxpayer prevails in that action. If no suit or proceeding is brought within thirty days of the payment, the taxes paid under protest become a government realization.

Section 40-35, HRS, requires, among other things, that the protest be in writing, signed by the person making the payment, or by the person's agent, and that it set forth the grounds of protest. This means that an oral statement to a department employee by the taxpayer that the taxpayer is paying taxes under protest does not meet the requirements of

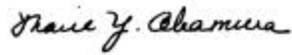
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this section. There must be a signed written statement setting forth the grounds of protest on the tax payment or on a separate transmittal filed with the payment.

Forms and other tax information may be downloaded from the Department's website at: www.state.hi.us/tax/. On Oahu, forms may be ordered by calling the Department's Form Request Line at: 808-587-7572. Persons who are not calling from Oahu may call: 1-800-222-7572 (toll-free) to receive forms by mail or by fax.



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Director of Taxation

Sections Explained: HRS 40-35, 231-7, 231-23, 231-24, 232-24, 235-2.45(k), 235-102, 235-105, 235-110, 235-111, 235-114, 237-37, 237-39, 237-40, 237-41, 237-42, 237D-11, 238-7, 238-8, 238-9, 244D-12, 245-10, 247-4.5, and 251-10

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