

TAX REVIEW COMMISSION

MINUTES OF THE TWELFTH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT 830 PUNCHBOWL STREET, ROOM 221
IN THE CITY AND COUNTY OF HONOLULU
STATE OF HAWAII, ON TUESDAY, APRIL 25, 2006

The Commissioners of the Tax Review Commission met at the Department of Taxation, Director Conference Room, in the City and County of Honolulu, State of Hawaii, on Tuesday, April 25, 2006.

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

Staff: Tu Duc Pham, Donald Rousslang, Josephine Malama

Other: Melanie King, Bank of Hawaii
Diane Erickson, Dept. of Attorney General
Peter Fritz, Chun Kerr Dodd Beaman & Wong
Tom Smyth, DBEDT
Kurt Kawafuchi, DOTAX
Johnnel Nakamura, DOTAX
Ronald Randall, DOTAX
Cathleen Tokishi, DOTAX

CALL TO ORDER

Chairman Isaac Choy called the meeting to order at 10:05 a.m. with a quorum present. He announced that we have a new Commission member, Melanie King, who was invited to the meeting. He thanked everyone for their hard work and for attending the Commission meetings.

APPROVE MINUTES OF MARCH 15, 2006, MEETING

It was moved by Mr. Heller and seconded by Mr. Roberts to approve the minutes of March 15, 2006. The motion carried without opposition.

REPORT ON THE STATUS OF CONTRACTS FOR EXTERNAL STUDIES

Dr. Rousslang reported that the contract for Dr. William Fox is being finalized. There are some technical issues with Dr. Marcia Sakai's study that should be resolved soon. Dr. Pham reported that Dr. Sakai will include the high technology tax credit in her study. She may request for some funds in advance. The request would have to go through the Administrative Services Office. There was concern that this request would pose a problem in getting the work done on time, but it will not.

REPORT ON ADDITIONAL SUGGESTIONS RECEIVED FROM THE PUBLIC

The Chairman thanked Mr. Heller for classifying the suggestions. Originally, there were 39 items, but after reopening to the public, an additional 12 were submitted. Chairman Choy announced that the Tax Review Commission will go through ten suggestions at a time; therefore, it will take several meetings to cover all 52 suggestions. He would like to ensure that the public is informed and encouraged to attend these meetings so they can come forward and qualify or amplify what they submitted. If not, the Commission members will discuss the suggestions among themselves and come to a conclusion. Due to time limitations, he asked if the Commission should set a deadline for accepting suggestions from the public or be open to more suggestions. Mr. Heller felt that the Commission should look at any that may be received and then decide to add them to the list or not.

REPORT ON SENATE CONCURRENT RESOLUTION (SCR) NO. 191

Dr. Pham reported that SCR 191 is dead. Several comments were made including not enough time to do a comprehensive analysis, conclusions were already made in the "whereas" clauses, no funds were appropriated, request may be beyond the statutory authority of the Tax Review Commission with its focus on state taxes, and the study and cost should be at least partly the responsibility of the counties. Ms. Niwao suggested that it would be a good idea for the Commission to look at property tax "circuit breakers." Mr. Choy agreed with Mr. Heller's assertion that the scope is so broad and so big that the counties should participate in such a study. Mr. Heller commented that the Legislature could expand the statute to include within the powers and duties of the Commission to look at the system of municipal taxes as well as state taxes, but that if they want a truly independent study, they should just appoint someone to do the study without preordaining the outcome. Dr. Grandy suggested that this Commission recommend that the next Tax Review Commission review county taxes too.

REPORT ON THE STATUS OF WORK ON RECOMMENDATIONS OF PREVIOUS COMMISSIONS

The Chairman reminded the Commissioners that this report was part of their assignment made at the January 31, 2006 meeting. This is the last part of their report due the end of summer. Dr. Rousslang reported that he will redo the worksheet so the asterisks on the last page (beginning with the miscellaneous section) align correctly. Ms. Ching asked if more information could be provided in the implementation section (i.e., date adopted, by what Act, and any additional details to explain the status of the recommendation). She sees no problem with the format. Dr. Rousslang will comply with the information requested. The Chairman reminded everyone that we are in the third quarter of the schedule.

During this discussion, Mr. Kawafuchi arrived with Ms. King. He introduced her as the seventh Commission member. She is awaiting confirmation by the full Senate, after which she will be sworn in by the Governor. She was formerly a senior tax manager at PricewaterhouseCoopers, and is currently head of the Bank of Hawaii Tax Department. The Chairman welcomed Ms. King to the Tax Review Commission.

REPORT ON THE STATUS OF WORK ON OTHER INTERNAL STUDIES

Review of the progressive and regressive nature of overall taxes. Dr. Rousslang reported that the information for this report is in the organizing stage, but they have a pretty good idea of how to proceed and it should be done on time.

Study on "tax adequacy" (how tax collections change automatically as income grows). Dr. Rousslang reported that most of the work has been done on this report. It's a matter of completing the write-up

Effects of an earned income tax credit. Dr. Pham reported that staff is working on the statistics by zip code. This is currently before the Legislature and seems likely to pass, but only 10% of the federal earned income tax credit.

Effects of increasing the standard deduction. Dr. Pham reported that this is also currently before the Legislature and seems likely to pass, but at 40% of the federal standard deduction; less than what was recommended by the past and current administrations.

Mr. Kawafuchi agreed that the Department is hopeful that these measures will pass, but that these and other tax relief measures will be fairly small. The House, especially, seems inclined to pass the earned income tax credit, but everyone is familiar with the federal experience with the earned income credit.

Effects of expanding the income tax brackets. Mr. Kawafuchi stated, when asked, that this measure is the least likely to pass because it costs the most money.

The Chairman asked to skip to item #10 of the agenda (Discuss Interaction of Commission's Work with Current Legislative Proposals) while on this topic. There was no objection.

Dr. Rousslang asked if legislation introduced should be considered by the Commission as a suggestion from the public to be considered by the Commission.

The Chairman asked if the Commissioners would like to review the list of tax legislation prepared by the Tax Foundation of Hawaii and treat them as suggestions from the public? Mr. Heller responded that the list is quite huge. If the Commission is inclined to do it, it should be narrowed to include only those proposals that survived crossover. He went on to say that if any of the proposals had broad, popular support, it would have popped up on our list; or if any of the Commission members had suggestions, those suggestions could be considered as well. The Commission need not go back and look at all of the legislative proposals for the last four or five years. Ms. Ching agreed due to time and budgetary constraints.

Mr. Kawafuchi stated that if there are any changes to be made, this year is the best opportunity to do it. Next year, there is hardly any chance because it is a negotiation year with the unions. While we have had revenue growth, it will be hard to sustain that double-digit growth. He feels that the economy will continue to grow but that there are many competing demands on that surplus and the demands on the surplus far exceed the amount of the surplus.

The Chairman noted that the Commission will probably study many of the tax proposals currently before the Legislature because they are also on the Commission's plate.

BEGIN EVALUATING SUGGESTIONS FROM THE PUBLIC

The Chairman reminded everyone that there are three areas of studies being done: external studies, internal studies, and administrative and statutory amendments that the Commission will recommend. Of the three, the administrative and statutory amendments are the easiest for the members to start making decisions on. It had been previously decided that the Commission will discuss ten suggestions at a time and try to make a decision afterwards. He further stated that he doesn't quite understand the suggestions as they were worded, and asked that anyone who has knowledge about the suggestion come forth and clarify the suggestion. If the minutes do not clearly reflect the suggestion, please suggest clarifying language. After each discussion, a decision will be called for.

18. Conform Hawaii's statute of limitation on collections to the ten-year federal limit.

Mr. Heller agreed with the suggestion. He felt going back beyond ten years may be difficult for the taxpayer as virtually nobody has records or proof of payment going back 20-25 years. The Department has stated that having such a statute would force them to be more aggressive in collecting delinquent taxes, but he's not sure that is entirely a bad thing.

Mr. Heller asked Mr. Randall to comment on this. Mr. Randall stated that it has been the State's policy for more than 25 years to work with the taxpayer. The hope is to work with the taxpayer to keep the business running and hope they can pay in the future. If a ten-year statute of limitations is imposed, he may have to create a civil unit to seize the assets and shut down the business to stop the bleeding; this is what the federal government does. During his years with the Department, he has seen one seizure of a jewelry shop in the 1980's and one other services station seizure. The Department has also started working with the Attorney General's Office on cross-jurisdictional issues.

The new computerized collection system (ICS) has also improved the billing process. Timely automated billing has increased the likelihood of collecting delinquent taxes. Collecting within 30 days is preferable; as you move beyond 180 days, collection becomes more difficult. The Department also has better access to tools that help locate taxpayers.

One problem is that, although there are cost recovery provisions, the money goes into the general fund rather than to the Department to be used for other cases. The Commission should consider these funding issues to allow them to do their job rather than imposing a 10-year statute of limitations.

The Chairman asked if Mr. Randall thought that collecting for 10 years is being super aggressive. Mr. Randall stated that it would force them to change from a philosophy of working with taxpayers (e.g., extending payment plans if the business is still doing okay and can make payments). When the taxpayer is unable to pay, most really want to satisfy the debt, but it would be better for them to stop doing business and just stop the bleeding.

Ms. Niwao stated that she knows that the Department has put liens on people's homes and let it go, but when real estate values rise, the taxpayer sells and the State gets its money. She's not necessarily in favor of taxpayers being forced to sell their home. Further discussion was held regarding the fairness issue – comparing the previously described taxpayers to others who pay on time.

Dr. Grandy asked if there are a lot of taxpayers who are delinquent over ten years? Mr. Randall responded that he'd have to check. However, the taxpayer locating service the Department has now is allowing it to find people who have moved out of State, etc., and the taxpayers are going to their tax professionals for help after getting caught all these years later; the Department does work with them.

Mr. Randall further stated that the Department also does some write-offs periodically and is working on an automated write-off program. In response to a comment by Mr. Heller, Mr. Randall explained that, when the Department writes off an account, it doesn't mean that we will do nothing more with that account. We will pursue it if the taxpayer resurfaces.

Mr. Heller stated that, should the Commission recommend this, implementation would need to be done on a prospective basis.

Further discussion was held with respect to whether the State should adopt the same 10-year period as the federal or whether it should be 10 + 1 years, particularly since the State has an additional year from the date it is notified of a federal assessment and the statute of limitations would begin from the date of the State assessment/date the return is filed and the debt established, and current federal practices as the end of the 10-year period approaches.

In response to Dr. Grandy, Mr. Heller stated that the two main reasons for recommending this change are: (1) that it imposes an unfair burden on taxpayers with respect to maintaining records proving payment; and (2) from the State's perspective, it would push them to get the revenue in faster because they don't have forever to do it. It was noted that the taxpayer has an obligation to pay and the State has an obligation to collect.

It was moved by Mr. Heller and seconded by Mr. Roberts that the Commission adopt this suggestion and recommend in favor of a 10-year statute of limitations for State collections. The motion was not passed with the following votes: 3-No 2-Yes.

The Chairman called for the vote:

Ronald Heller	Yes
John Roberts	Yes
Carolyn Ching	No
Chris Grandy	No
Lon Okada	No

19. Enforce income tax compliance for HARPTA non-resident aliens – make sure they file an income tax return. (This suggestion also covers the suggestion to deny HARPTA approval if the taxpayer fails to file a year-end return.)

The Chairman called for clarification of this suggestion, which had come from Ms. Niwao. Ms. Niwao expressed concern over the nonresident aliens who do not report the sale of their real estate in Hawaii. The maximum tax on net capital gain is 7.25% while the amount of tax withheld under HARPTA is only 5%. This can be problematic if the property has greatly appreciated, particularly if depreciation had been claimed such that the basis in the property for determining the net gain is much lower than the sales price; in this case the 5% may be less than the actual tax due on the transaction.

Ms. Ching pointed out that the 5% is withheld from the gross sales price rather than the gain. Ms. Niwao stated that the 5% still is not necessarily enough, and the State fails to pursue the taxpayer assuming that the 5% is sufficient. She noted that there is a bill currently before the Legislature, H.B. 1800, that would raise the HARPTA withholding to 8%, which as Dr. Pham pointed out, is more than the 7.25% maximum rate on net capital gains. However, Ms. Niwao noted that, in at least some cases, the taxpayers have also failed to pay the general excise tax (GET) and transient accommodations tax (TAT).

Ms. Niwao stated that she's heard of cases on Maui where the attorneys have advised their clients to pay the back GET, but then someone at the tax office has advised that they not pay. Increasing the withholding rate may force them to seek out a tax practitioner thus increasing the chances of the GET and TAT being paid.

The Chairman asked if the suggestion should be clarified to read, increase income tax compliance by increasing the HARPTA withholding from nonresident aliens to force them to file a return, which will trigger compliance action if the general excise or other taxes are not being paid.

Ms. Tokishi asked about the impact on the Department due to a potential increase in the filing of N-288C forms to obtain a tentative refund of the tax withheld. Ms. Niwao stated that the Department would get increased filing of Forms N-288C, and Mr. Heller noted that the Department may also see an increase in the filing of Forms N-288B to obtain an exception to the withholding.

Mr. Randall noted that legislation is needed to provide for penalties on the withholding agents (primarily the escrow companies) who withhold, play the 20-day float, and then fail to pay the money over to the State. Mr. Randall commented that staffing is an issue and that the work in this area is limited to what the staff can do. Mr. Roberts stated that it may be possible to cross check with county real property tax records, and do more upfront educational efforts at the time of sale rather than after the fact collection activities. However, Mr. Randall stated that those methods involve the manual checking of records, and given limited resources, that is not an efficient use of those resources.

The Chairman had 3 questions.

First, how much money is the State losing due to noncompliance by nonresident aliens selling property, or rather to nonresidents of Hawaii since HARPTA does not only apply to nonresident aliens? There is no ballpark figure.

Second, do the members think that an increase in the withholding will have an impact on real estate sales? Depends; 8% probably not, 20% probably will (note that 20% was the figure originally used in H.B. 1800).

Third, what would happen if the exemption form were just eliminated? Mr. Heller felt it would create a lot of mechanical problems for transactions that either don't involve cash or that don't involve sufficient cash in addition to other types of transactions. It was also pointed out that the exemption form (N-289) is also used by residents to indicate that they are not subject to the HARPTA provisions.

It was suggested that the statement be clarified to say: "To enforce total tax compliance by nonresidents, the HARPTA withholding rate should be increased and penalties imposed on withholding agents for noncompliance."

It was noted that there currently are no penalties for noncompliance with HARPTA withholding.

It was moved by Mr. Roberts and seconded by Ms. Ching to revise the statement as suggested and to accept "To enforce total tax compliance by nonresidents, the HARPTA withholding rate should be increased and penalties imposed on withholding agents for noncompliance". The motion passed with the following votes: 4-Yes 1-Abstain.

The Chairman called for the vote:

John Roberts	Yes
Carolyn Ching	Yes
Lon Okada	Yes
Chris Grandy	Yes
Ronald Heller	Abstain

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

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

The Chairman asked for clarification. Mr. Heller stated that he assumes that it refers to when Hawaii property is exchanged for mainland property and the taxpayer fails to report any gain to Hawaii when the out-of-state property is subsequently sold. The State should get some of the money at the time the Hawaii property is exchanged, or there is an alternative suggestion on the list to only allow a tax-free exchange when the property is exchanged for Hawaii replacement property. Mr. Heller pointed out that this would be a major change in tax policy.

The Chairman asked what was meant by, "any shortfall." Mr. Heller stated that he felt that referred to any additional cash (i.e., "boot") received in addition to the replacement property. You could only take money out of any cash.

Mr. Roberts asked if there was an interstate commerce issue. Ms. Niwao stated that for federal tax purposes, property could not be exchanged for foreign property. Ms. Ching stated that she is seeing many instances in which Hawaii property is being exchanged for out-of-state property because you don't want to exchange the Hawaii property for another high market property; they are instead going to Denver, Nevada, Texas, and other locations. Ms. Niwao agreed that taxpayers are taking the profit on the Hawaii property out-of-state and subsequently recognizing the gain in states that do not impose an income tax.

Mr. Heller stated, and others agreed, that taking 5% of any cash is not a very effective means of dealing with this issue. Problematic when there is no cash.

Dr. Rousslang read the actual suggestion submitted, which dealt with allowing the facilitator of a 1031 exchange to withhold and pay to the State a percentage of any shortfall. The members

agreed that it sounded very much like HARPTA. However the mechanics of implementing such a recommendation would be difficult.

It was unanimously agreed that the two suggestions stated above would be deferred. The Commission members asked for a copy of the original suggestions. Jo will make copies for the members.

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

Mr. Roberts stated that, at least on Maui, not every lessor uses a Hawaii rental agent; especially those from Canada, the mainland, etc. He cannot quantify how much is being lost in tax revenue, but this suggestion is more a suggestion for the education of lessors at the time they purchase the property plus compliance action to ensure that general excise, transient accommodations, and net income taxes are being paid.

Compliance would generally require an audit. Mr. Heller pointed out that the Commission could not only recommend changes to the law, but also to changes in Department of Taxation procedures, such that they recommend that audit resources be used to target this area.

It was unanimously agreed that this suggestion would be deferred and combined with other nonresident issues, including HARPTA issues. The Chairman will work with Dr. Rousslang to come up with an appropriate restatement of this suggestion.

24. The three-year statute of limitations on assessment of the GET should not run from the filing of the annual reconciliation GET return (Form G-49).

The statute of limitations runs from the due date of the annual return or when the annual return is filed if later. Mr. Heller agrees with this suggestion. In some cases, taxpayers may file all periodic general excise tax returns but be unaware of the requirement that an annual return also be filed. He does not see any policy reason why the statute of limitations should not start running if the taxpayer has filed all required periodic returns.

The original suggestion was to have the statute of limitations run from the due date of the periodic returns. Mr. Heller thinks this is too complex. His suggestion is that it should run from the filing of the last of the periodic returns. For example, if a monthly filer filed periodic returns for all months except for the month of May, the statute of limitations would begin running when the May return was filed. Likewise for quarterly and semiannual filers.

Ms. Niwao pointed out that the Department's new computer system, unlike the system it replaced, does send out notices to taxpayers when they fail to file their annual return. As a result, this is not as much a problem now as it was in the past.

Mr. Heller agrees, but still thinks it is unfair to penalize someone who files all periodic returns just because they missed the annual return. The Chairman noted that he always thought that the

G-45 periodic returns were estimates and that the G-49 was the return. Ms. Ching agreed, as did Ms. Niwao.

Dr. Grandy asked if this was an education issue. Can this be handled by having a mechanism to remind people to file the annual return? The Chairman said that this relates to suggestion 52 to place the burden on the State to remind people. Ms. Nakamura had a problem with putting the burden on the State to remind people to file their returns; ultimately it is the taxpayer's responsibility.

The Chairman agreed, except that, as the tax laws get more complex, the state should contribute to the education and reminder process. Ms. Nakamura stated that, this gets back to the Department's resources problem.

It was moved by Mr. Heller and seconded by Mr. Okada to accept "The three-year statute of limitations on assessment of the GET should start from the filing of the last of the periodic GET returns (Form G-45). The motion was passed with the following votes: 4-Yes 1-No.

The Chairman called for the vote:

Ronald Heller	Yes
Lon Okada	Yes
John Roberts	Yes
Carolyn Ching	Yes
Chris Grandy	No

25. Prohibit reopening expired statutes of limitations to assess income tax and GET

Ms. Nakamura expressed concern that this would prohibit the State from auditing a return and issuing an assessment within one year of being notified of federal adjustments, which is frequently after the normal three-year statute of limitations period has expired. Mr. Heller clarified that this also applies to refunds. He agrees that the reopening of the statute of limitations for some limited period, as in this instance to allow the state to make a parallel adjustment to the federal adjustment, is appropriate.

It was moved by Mr. Roberts and seconded by Ms. Ching to approve "Prohibit reopening expired statutes of limitations to assess income tax and GET". The motion did not pass with the following votes: 5-No.

The Chairman called for the vote:

Ronald Heller	No
Carolyn Ching	No
John Roberts	No
Lon Okada	No
Chris Grandy	No

26. Make public private rulings, advice and settlements made by the Department.

Mr. Heller feels that more discussion is necessary than they have time for in the present meeting, but he has some real problems with this suggestion. Many taxpayers have problems that they resolve by settling, and he doesn't feel that they should lose the confidentiality of tax return information simply because they happened to get audited and disagreed with the auditor's findings. If you go to court, you will lose confidentiality because court records are public. The only way to keep it private is to settle. What this proposal would mean is that everyone who gets audited loses their privacy if there is any change in the audit; that is both drastic and unfair to taxpayers.

Mr. Smyth stated that there are differences between rulings, advice, and settlements, and there is value in the public knowing about advice. Ms. Nakamura stated that you must be careful about advice to whom. Mr. Smyth reiterated that there is a difference between rulings and advice on one hand and settlements on the other.

Mr. Heller said that he had pointed out in his earlier memo that there is a provision of law allowing disclosure of certain kinds of rulings. One is an analysis of the tax law and how it applies, and those are already public record with the taxpayer's name redacted. But there is another kind of letter, which takes established law and applies it to a particular fact situation; this type of letter is not public record. Most opinion letters have been classified as the latter type. That's more an administrative or definition issue. Making all such rulings public may discourage people from coming to the Department for guidance, and there may even be situations in which a reader could figure out who the taxpayer was. Settlements should remain private, but a closer look at rulings and advice is needed.

Mr. Smyth pointed out that both the Ethics Commission and the Ombudsman's Office published their rulings.

Ms. Nakamura stated that we would need something like IRC §6110 specifying what had to be redacted.

Further discussion was held regarding the balance between the general consensus that settlements should remain confidential and the issue of fairness (i.e., the perception that there may be "back room deals"). Ms. Nakamura pointed out that settlements are so factual. Different circumstances, for example collectibility, may make a settlement appropriate in one case but not in another, but that these differences may not be clear in a settlement agreement which then may be questioned if made public.

Mr. Heller agreed, citing instances where the Department may look at how credible potential witnesses are should a case be litigated, and then enter into a more favorable settlement when the witnesses are more credible.

Dr. Grandy expressed concern about the potential for abuse by the Department and the transparency issue.

It was decided to defer decision-making on this suggestion and to continue the discussion at the next meeting.

In the interest of time, the last three suggestions on the agenda were also deferred to the next meeting.

ANNOUNCEMENT

The Chairman announced that Ms. Malama would be leaving the Tax Department for a permanent position with the Hawaii Paroling Authority on May 16, 2006. Ms. Tokishi will be taking the minutes of the TRC meetings.

The next Tax Review Commission meeting will be on May 30, 2006, at 10:00 a.m.

ADJOURNMENT

It was moved by Mr. Heller and seconded by Mr. Okada to adjourn the meeting at 12:10 p.m. The motion was carried unanimously.