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To: The Honorable Sean Quinlan, Chair;
The Honorable Daniel Holt, Vice Chair;
and Members of the House Committee on Economic Development

From: Isaac W. Choy, Director
Department of Taxation

Date: Friday, February 11, 2022
Time: 2:00 P.M.
Place: Via Video Conference, State Capitol

Re: H.B. 2177, H.D. 1, Relating to State Tax Administration

The Department of Taxation (Department) strongly supports H.B. 2177, H.D.1, an Administration measure, and offers the following comments for the committee's consideration.

H.B. 2177, H.D. 1, makes the following important changes to Hawaii tax law in Chapters 231, 232, and 235, Hawaii Revised Statutes (HRS):

- Improves the Department's flexibility in requiring certain taxpayers to file electronically;
- Enhances accountability for paid tax return preparers;
- Modernizes the out-of-date rules and penalties for electronic funds transfer;
- Updates state law to eliminate redundancies and reflect current administrative processes;
- Clarifies the penalty provisions for failure to file informational returns;
- Adds necessary administrative provision to the withholding liability of certain entities for nonresident taxpayers' distributive share of income; and
- Clarifies the interest rate that the State must pay to taxpayers who have paid into the litigated claims fund and are due a refund.

H.B. 2177, H.D.1, is effective upon approval, with changes to electronic filing effective July 1, 2022.

These tax law changes will be a tremendous benefit to the State, both in increasing tax compliance and in streamlining administrative processes, and will also help provide taxpayers more clarity while minimizing their exposure to unexpected penalties.

The Department is in strong support of this bill and is able to implement the measure as currently drafted. Thank you for the opportunity to testify.

Richard Paul McClellan III
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February 9, 2022

Rep. Aaron Ling Johanson, Chair
Rep. Lisa Kitagawa, Vice Chair
Members of the House Committee On Consumer Protection & Commerce

Re: **HB 2177 Relating to State Tax Administration**

Hearing Date: 2/11/2022, 2:00 PM

Dear Chair Quinlan, Vice-Chair Holt, & Honorable Committee Members:

I strongly oppose *additional penalties* for late filing. Hawaii's current standard of 25% (5% per month for 5 months) plus 8% interest is more than adequate to deter late filing.

This bill imposes harsh penalties for persons (5% per month for 15 months) that file *just a day late* and are unable to pay in full.

Should this bill become law, the Department of Taxation will be able to collect substantial amounts of penalty and interest (8%) from the working poor (sometimes "ALICE") that require payment plans to retire delinquencies.

The Department of Taxation reported to you that it has approximately 67,000 active cases, suggesting that a meaningful percentage of all working adults in the State owe the State taxes.

Imposing new types of penalties on persons unable to navigate the Department's computer system due to personal characteristics or limited means is not responsible policy as it decreases the respect for the law and demotivates persons to resolve their debts.

1. SECTION 1. Penalties for Paper Filing & Income Tax Paper Payments

The Department of Taxation's e-filing system, while a vast improvement over prior systems, is not user friendly for persons with disabilities and persons with limited access to computers and trying to manage their affairs by smart phone.

The bill targets penalties for exactly these disabled and low-dollar, low-revenue segment of our economy and the $4,000 thresholds for GE and TA should remain in place for e-filing.

As for Section 2, (1)(a), it is counterproductive to impose penalties for paying via check instead of e-transfer for income tax returns. E-transfer requires a financial account and significant number of law abiding persons are unable to afford a financial account with its fees, especially overdraft fees.

The laws of this State should encourage delinquent persons to pay electronically, by check, by US money order, or by delivering cash to the Department's cashiers. Payment should be as easy as possible based upon the person's circumstances.

Nobody should ever be penalized for paying. Nobody should ever be penalized because their economic condition does not permit them to maintain a financial account without incurring fees and especially penalties for overdrafts.

2. SECTION 5 Increasing Late Filing/Payment Penalties to 75%

The bill in Section 5 proposes to increase late filing/payment penalties from 5% per month/5 months (25% maximum) to 5% per month/15 months (75% maximum).

If enacted, this proposal would go a long way to rapidly making penalties and interest exceed the tax principal in a short period of time, within two years. Especially if a late filer/late payer gets a 9% penalty the first month (5% late filing, 2%/2% failure to e-file/failure to e-pay.)

As for "innocent mistakes," most inadvertent mistakes in terms of late filing do not qualify under Hawaii law for "reasonable cause and not due to neglect." The "not due to neglect" can be especially hard to satisfy.

This section should be rejected.

3. SECTION 5. Informational Return Penalty

Section 5. The measure proposes to impose penalties along federal lines for failure to file informational returns.

The Department of Taxation should be required to show that it is using the data on the informational returns itself, *as opposed to importing it from the Internal Revenue Service*, before such penalties are possibly warranted.

4. Policy Comment

By and large, penalties apply to persons that have made small mistakes, frequently in withholding with multiple jobs.

Staggering penalty rates are not the answer and are unseemly.

/s/ Richard McClellan

SUBJECT: ADMINISTRATION, INCOME, Mandatory E-Filing and E-Payment; Penalty Enhancement; Nonresident Quarterly Withholding

BILL NUMBER: HB 2177 HD 1

INTRODUCED BY: House Committee on Economic Development

EXECUTIVE SUMMARY: Allows the Department of Taxation to mandate the electronic filing of certain individual, partnership, S-corporation, general excise and transient accommodations tax returns. Requires certain tax return preparers to file returns electronically. Amends the rules for electronic funds transfer to remove the authorization to require electronic funds transfer or electronic filing if the federal government required that person to file or pay electronically. Removes the timeliness requirement from the electronic funds transfer penalty. Removes the authority of the department to charge for certified copies of tax clearances. Amends the statute that mandates tax clearances for liquor license holders. Increases the aggregate cap on late filing penalties from twenty-five per cent to seventy-five per cent. Adds an additional penalty category for late filing of certain informational returns where no tax is due. Clarifies the interest calculations for taxes paid pending appeal. Provides that a partnership, estate, or trust is liable for the required withholding from a nonresident taxpayer's distributive share of income.

SYNOPSIS: Amends section 231-8.5, HRS, to allow the department to require more classes of taxpayers to file electronically, including GE and TA filers with more than $2,000 in annual liability (threshold under existing law is $4,000). Allows the department to determine a penalty by administrative rule for returns where no tax is required to be shown on the return.

Requires tax preparers expecting to prepare more than 10 returns in a calendar year to file all tax returns electronically if an electronic filing option is available, and imposes a $50 penalty on both the preparer and the taxpayer for failure to file electronically.

Amends section 231-9.9, HRS, to require tax return preparers expecting to prepare more than 10 returns in a calendar year to remit the payment of taxes by electronic funds transfer. Deletes language that now allows the director to grant an exemption to electronic filing and payment requirements for good cause.

Amends section 231-10.8, HRS, to delete the department’s authority to charge $5 for each certified copy of a tax clearance.

Amends section 231-28, HRS, to allow the department to disclose tax information relevant to a prospective liquor licensee’s tax compliance to the licensing agency.

Amends section 231-39(b)(1), HRS, to allow the penalty for filing a tax return late, which now is capped at 25% of the tax deficiency, to swell to 75% of the tax deficiency.

Amends section 231-39, HRS, to add a new paragraph imposing a penalty of $200 per partner, shareholder, or beneficiary for each month that an informational return (such as a partnership return or S corporation return) is not filed on time, up to a maximum of twelve months.

Amends section 232-24, HRS, to provide that where disputed taxes are paid pending appeal in the litigated claims fund and the taxpayer wins at least part of the dispute, the interest rate in IRC section 6621(a) will no longer be used. Instead, the following rates apply: (1) For corporations whose overpayments are $10,000 or less, 3%; (2) For corporations whose overpayments exceed $10,000, 1.5%; and (3) For all other taxpayers, 4%.

Amends section 235-64.2, HRS, to require partnerships, estates, and trusts that are withholding tax on behalf of their nonresident owners or beneficiaries to remit tax payments quarterly.

Makes other technical and conforming changes.

EFFECTIVE DATE: January 1, 2023; changes to E-filing effective on July 1, 2022.

STAFF COMMENTS: This is an omnibus Administration bill sponsored by the department of taxation and designated TAX-03 (22). It may look like a purely technical bill to tweak the niceties of tax administration, but there are some blockbusters buried inside.

Tripled Penalty for Filing a Late Return. The ceiling on this penalty gets jacked up to 75%, and that is before other penalties are applied. Unlike the comparable federal penalties, Hawaii penalties stack. Under present law, a non-filer can and does get written up for 70% in penalties (25% for late filing, 25% for negligence, 20% for substantial underpayment of tax). This will go up to **120%** (75% for late filing, 25% for negligence, 20% for substantial underpayment of tax).

Penalty for Failure to File Partnership, S Corporation, or Trust Returns. This type of penalty can add up very quickly. A partnership with 100 partners, for example, that files a year late could face a bill of 100 partners x 12 months x $200 = $240,000. This penalty is similar to that provided in section 6698 and 6699 of the Internal Revenue Code.

Interest on Tax Paid Pending Appeal: We need to remember that this interest is only paid on money that is adjudged to be overpaid. We are concerned that keeping this rate artificially low does not fairly compensate the taxpayer for the loss of its money during the years an appeal is pending and could incentivize the department to take outlandish or unjustifiable positions on appeal. A fairer method would be to pay the taxpayer the actual earnings of the litigated claims fund on the money that is determined to belong to the taxpayer. This was the approach for several years under *Hawaiian Land Co. v. Kamaka,* 56 Haw. 655, 661-62, 547 P.2d 581, 585 (1976).

Digested: 2/10/2022