Predictions For 2015: Hawai'i Tax Compliance Forecast

Here are three trends to look for in 2015 from the Hawaii Department of Taxation:

- Increased audits and assessments;
- Increased attention to unreported vacation rentals; and,
- Review and audit of solar credit ("RETITC") claims filed in 2012 and 2013.

Increased Audits and Assessments

Hawaii's now-Governor, David Ige, campaigned in part on increasing the collection of taxes:

> *Tax backlog*. Another way to balance our budget is to collect taxes owed. Currently a total of $450 million is owed to the State in back taxes. Rather than raising taxes, I will secure the necessary resources for the State Department of Taxation to collect these back taxes.
>
> Source: http://www.davidige.org/action-plan/

This discussion appears on the first substantive page of Mr. Ige's action plan – its not buried deep in pages of text. Candidate Ige also stated that "as much as $500 million" may be out there to collect.

While campaign rhetoric may be discounted, in his proposed budget ("Interim Budget") released in late December 2014, Governor Ige has continued the allocation of $32M to improve computer systems for the Department of Taxation, at the rate of $16M per year for two years. In the same Interim Budget, performance measures for the DoTax Compliance Division reflect an intention to increase (from FY 2014-15 to 2015-16):

- the number of returns audited;
- the number of assessment; and,
- the number of tax levies processed.

See, Interim Budget, p 1318, "Performance Measures And Program Revenues."

Most significantly, audits are projected to increase from 1.01% of returns filed to 2.60%.

So, what is the trend? Governor Ige intends to collect more taxes and the Department of Taxation will conduct more audits (150% more), produce more assessments (tax bills,) and increase the number of tax levies and wage garnishments by 8%.   Only four (4) net positions will be added.

Without increased staffing, these audits will presumably be correspondence audits with some level of examiner supervision. With respect to levies and garnishments, the Interim Budget may reflect a policy change, that is, to simply increase the number of levies by the Collection Division. Possibly, the $32M computer system will be capable of identifying potential levy targets and issuing levies, similar to the Internal Revenue Service's ACS.

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Increased Attention To Unlicensed, Unreported Vacation Rentals

Vacation rentals have long been an issue in Hawaii. In the past several months, there have been a number of news stories in local media (Honolulu StarAdvertiser, Honolulu Civil Beat, and others) relating to vacation rentals. The Honolulu City Council is considering a zoning measure that could potentially increase the number of units available for vacation rentals.

In December 2014, the Hawaii Tourism Authority issued a report, authored by SMS Research, on "Individually Advertised Units In Hawai'i (Vacation Rentals.)" The purpose of the study was to determine the number of vacation rental units in Hawaii being advertised individually on the internet. The SMS Report visited websites such as www.vrbo.com, www.clearstay.com, www.tripadvisor.com, and www.airbnb.com . The Report concluded that Individual Vacation Rentals constitute approximately 25% of Hawaii's lodging capacity.

The SMS Report is a description of available units, not an evaluation or impact study. Local media, however, moves quickly to evaluation:

- "illegal"
- "contributing to a reduction in state tax revenue"
- "likely leaving millions of tax dollars uncollected"

Honolulu's daily, the StarAdvertiser has run articles, including a "Rogue Rentals" series, on "illegal" vacation rentals, speculating that many are not paying GE and TA taxes.

In this respect, in the Interim Budget, the Department of Taxation has stated objectives of "examination and assessment of out-of-state taxpayers" and "increasing voluntary compliance with statutory registration and filing requirements." P 1319.

If the SMS report is accurate, the individually advertised vacation rental industry may be significantly larger than previously recognized. As noted above, the industry may be expanded due to zoning changes being considered by the City & County of Honolulu.

From the Department of Taxation's point of view, because GE & TA taxes combined are 13-14% of gross revenue, with penalties at 25-50% of tax due and interest at 8%, even a relatively modest unreported rental can produce an assessment of $5,000 per year. With a potentially significant number of unfiled tax years, the DoTax has a significant incentive to identify and assess non-compliant properties.

As I have commented before, rental properties are particularly susceptible to computer sorting techniques and office audits. The recent requirements to post a tax identification number on any on-line advertisement for a vacation rental and requiring associations to report suspected rental units may make identifying non-compliant rental units easier.

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Renewable Energy/Solar Tax Credits Claimed in Years 2012 and 2013.

The solar industry expanded dramatically in Hawaii over the past five years. Part of this expansion was due to Hawaii tax credits. As I have written elsewhere, in November 2012, the DoTax issued Temporary Administrative Rules with respect to Renewable Energy ("RETITC") Tax Credits. The Temporary Rules became final in 2013. The temporary and final rules imposed various requirements to claim RETITC credits, or, put another way, the new rules provided the DoTax with new reasons to deny credit claims.

Numerous solar installations in 2012 and 2013 probably did not comply with the Temporary and Final Rules.

Hawaii law requires the RETITC credit claims to be filed within twelve months of the close of the taxable year for which the credit is applicable. See, Hawaii Revised Statutes 235-12.5(f), here. Claims not filed in this period are waived. Because of this requirement, carefully timed audits are particularly effective because this look-back period may prevent an amendment or claim in a subsequent year. For example, on January 1, 2015, claims that should properly have been made in 2013, but were not, are barred. The major impact will be on systems for which credits were claimed in 2012. Under the regulations, residential systems that were not permitted or properly permitted, did not timely pass inspection, or were not physically installed as claimed may be vulnerable.

RETITC claims are made on separate tax forms and thus can easily be identified and sorted by the DoTax. The Administrative Rules contemplate a building permit and passing building inspection, both which can be verified on-line (at least for Honolulu installations.)

Thus, identifying and examining RETITC credits for certain deficiencies may be a straightforward process, as opposed to attempting to identify unreported income or overstated deductions. Disallowing tax credits typically produces a direct benefit to the General Fund, either through the denial of a refund that would otherwise be issued or an assessment with penalties and interest.

The RETITC Credit is the first substantive drop-down menu on the Department of Taxation website and is likely to remain a Department priority. In 2014, RETITC Credit review was a "special project" at the Oahu Office Audit Branch.

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