TEMPORARY ADMINISTRATIVE RULES

THESE ADMINISTRATIVE RULES ARE TEMPORARY RULES ISSUED PURSUANT TO SECTION 231-10.7, HAWAII REVISED STATUTES.

AS TEMPORARY RULES, THESE ADMINISTRATIVE RULES BECOME EFFECTIVE SEVEN DAYS AFTER PUBLIC NOTICE IS ISSUED. THESE TEMPORARY ADMINISTRATIVE RULES TAKE EFFECT ON SEP 14 2009.

TEMPORARY ADMINISTRATIVE RULES ARE EFFECTIVE FOR EIGHTEEN MONTHS. THESE TEMPORARY ADMINISTRATIVE RULES WILL EXPIRE ON MAR 14 2011.

PERMANENT ADMINISTRATIVE RULES, SUBJECT TO THE PROCEDURAL REQUIREMENTS OF CHAPTER 91, HAWAII REVISED STATUTES (THE HAWAII ADMINISTRATIVE PROCEDURES ACT), ARE SIMULTANEOUSLY BEING PROPOSED FOR FORMAL ADOPTION.

DEPARTMENT OF TAXATION

Adoption of Chapter 18-231
Hawaii Administrative Rules
AUG 26, 2009

SUMMARY

1. A new §18-231-10.6-01T is added.
2. A new §18-231-36.5-01-6694T is added.
3. A new §18-231-36.6-01-6662T is added.
4. A new §18-231-36.7-01-6700T is added.
5. A new §18-231-36.8-01-6676T is added.

HAWAII ADMINISTRATIVE RULES

TITLE 18

DEPARTMENT OF TAXATION

CHAPTER 231

ADMINISTRATION OF TAXES

ADMINISTRATIVE GUIDANCE APPLICABLE TO
CERTAIN PENALTIES AND FINES

§18-231-10.6-01T	Administrative guidance applicable to certain penalties and fines; general intent in application of provisions.
§18-231-36.5-01-6694T	Guidance, understatement of taxpayer liability by tax return preparer; conformity to treasury regulations related to Internal Revenue Code section 6694.
§18-231-36.6-01-6662T	Guidance; substantial understatements or misstatements of amounts; conformity to treasury regulations related to Internal Revenue Code section 6662.
§18-231-36.7-01-6700T	Guidance, promoting abusive tax shelters; conformity to treasury regulations related to Internal Revenue Code section 6700.
§18-231-36.8-01-6676T	Guidance, erroneous claim for refund or credit; conformity to treasury regulations related to Internal Revenue Code section 6676.

1. Chapter 18-231, Hawaii Administrative Rules, is amended by adding a new temporary section 18-231-10.6-01T to read as follows:

"ADMINISTRATIVE GUIDANCE APPLICABLE TO
CERTAIN PENALTIES AND FINES

§18-231-10.6-01T Administrative guidance applicable to certain penalties and fines; general intent in application of provisions. (a) Section 231-10.6, HRS, requires the department to provide taxpayers and tax return prepares with guidance on

the application of penalties or fines that may be imposed by the following provisions:

(1) Understatement of tax liabilities by tax return preparers under section 231-36.5, HRS (Internal Revenue Code section 6694);

(2) Substantial understatements or misstatements of tax under section 231-36.6 (Internal Revenue Code section 6662), HRS.

(3) Promoting abusive tax shelters under section 231-36.7, HRS (Internal Revenue Code section 6700);

(4) Erroneous claims for refund or credit under section 231-36.8, HRS (Internal Revenue Code section 6676);

Each of the foregoing penalties references the federal statutory counterpart contained in the Internal Revenue Code and requires the construction of these penalties to be made based upon federal regulatory and judicial guidance.

(b) Section 231-10.6, HRS, allows the department to utilize federal laws and administrative guidance in carrying out the purpose of that section.

(c) In addition to the regulatory guidance requirement of section 231-10.6, HRS, section 235-2.5, HRS, authorizes the department to conform to any administrative provision of the Internal Revenue Code, title 26, United States Code (subtitle F, sections 6001 to 7873), not in conflict with or similar to provisions contained in chapters 231, 232, or 235, HRS. The department is authorized to adopt these provisions by reference or by setting them forth in full.

(d) The purpose of this section and sections 18-231-36.5-01 through 18-231-36.8-01, HAR, is to carry out the intent of sections 231-10.6 and 235-2.5, HRS, by providing relevant guidance in a manner that conforms to the greatest extent practicable under the circumstances to the administrative provisions of the Internal Revenue Code referenced in subsection (a). In order to ensure optimal conformance, the relevant similar provisions of the Internal Revenue Code will be interpreted and administered as provided by adopting the rules and regulations promulgated by the United States Secretary of Treasury, or a delegate of the Secretary, by reference.

(e) For purposes of this section and sections 18-231-36.5-01 through 18-231-36.8-01, HAR, the provisions of the rules and regulations promulgated by the United States Secretary of Treasury implementing provisions of the Internal Revenue Code, which are adopted by reference, shall be made operative and be incorporated by reference, except where expressly inconsistent with the statutory provisions of title 14, HRS, in which case the statutory provision of the HRS shall control. The treasury rules and regulations shall be applied using changes in

nomenclature and other language, including the omission of inapplicable or irrelevant language, where necessary to effectuate the intent of this section.

(f) Where treasury regulations include references to temporary or proposed treasury regulations that are inconsistent with final treasury regulations, the treasury regulations most consistent with the statutory provisions of the relevant sections of the HRS set forth in subsection (a), whether proposed, temporary, or final treasury regulations, shall control.

For example, the penalty set forth under section 231-36.5, HRS, which provides a penalty for understatements of tax liability by tax return preparers similar to section 6694 of the Internal Revenue Code, assesses a penalty for taking "unreasonable positions" that were not disclosed on a tax return. Prior to enactment of section 231-36.5, HRS, the federal counterpart (section 6694 of the Internal Revenue Code) assessed a penalty for taking "unrealistic positions" and also included treasury regulations interpreting this phrase. Congress subsequently amended this section to increase the standard required in taking an undisclosed position on a tax return. The Secretary of Treasury provided guidance on the increased standard through issuance of proposed regulations. Soon thereafter, Congress amended the standard again to which section 231-36.5, HRS, now conforms. As a result of repeat statutory changes by Congress, there are conflicting treasury regulations discussing the current standard. In application of the conflicting regulation standards, the final regulations will control to the extent not in conflict with section 231-36.5, HRS. Furthermore, proposed regulations will control to the extent the proposed regulations expand upon principles not discussed in the final regulations and which are not in conflict with section 231-36.5, HRS.

(g) The director may clarify specific provisions of treasury regulations adopted by reference under sections 18-231-36.5-01 through 18-231-36.8-01, HAR, by Tax Information Release or other formal pronouncement.

(h) With regard to the penalties set forth in subsection (a), the director shall approve assessed penalties prior to assessment, as required by section 231-10.6, HRS.

(i) The purpose and intent of this section is applicable to sections 18-231-36.5-01 through 18-231-36.8-01, HAR.

(i) Nothing contained in this section shall limit the department's ability to provide guidance, examples, and safe harbors in addition to those provided by treasury regulations." [Eff SEP 1 4 2009] (Auth: HRS §§ 231-3(9), 235-2.5(b), 231-10.6, 235-118) (Imp: HRS §§ 231-10.6)

2. Chapter 18-231, Hawaii Administrative Rules, is amended by adding a new temporary section 18-231-36.5-01T to read as follows:

"**§18-231-36.5-01-6694T Guidance, understatement of taxpayer liability by tax return preparer; conformity to treasury regulations related to Internal Revenue Code section 6694.** (a) In administering the penalty set forth under section 231-36.5, HRS, relating to imposition of a penalty for understatements of taxpayer liability by a tax return preparer, the following treasury regulations shall be operative:

(1) Title 26, code of federal regulations, section 1.6694-1;

(2) Title 26, code of federal regulations, section 1.6694-2;

(3) Title 26, code of federal regulations, section 1.6694-3;

(4) Title 26, code of federal regulations, section 1.6694-4.

(b) The director may prescribe a list of positions that the director believes do not meet the substantial authority standard. Such list (and any revisions thereof) shall be published and made public by Tax Information Release.

(c) The director may adopt additional examples and other administrative guidance pursuant to Tax Information Release.

(d) Action to enjoin a tax return preparer. Section 231-36.5(g), HRS, authorizes the director to seek an injunction from a court enjoining a tax return preparer from preparing tax returns in certain circumstances. A civil action to enjoin a tax preparer shall be subject to the following procedures:

(1) A civil action to enjoin a tax return preparer shall be brought by the attorney general at the director's request.

(2) The civil action to enjoin a tax return preparer shall be based upon facts alleging conduct by the tax return preparer that is prohibited under sections 231-36.5(a) or (b), or both.

(3) The civil action shall be brought in the circuit court where the tax return preparer resides, has a principal place of business, or where the taxpayer with respect to whose tax return the action is brought resides, at the election of the director.

(4) An injunction enjoining a tax return preparer shall be effective upon the issuance of a court order after a finding by the court that injunctive relief is

appropriate to prevent the recurrence of conduct prohibited under sections 231-36.5(a) or (b), or both.

(5) Where a court finds that a tax return preparer has continually or repeatedly engaged in conduct prohibited under sections 231-36.5(a) or (b), and that an injunction prohibiting that conduct would not be sufficient to prevent the preparer's interference with the proper administration of chapter 231, which is applicable to all of title 14, HRS, the court may enjoin the preparer from acting as a tax return preparer in any capacity." [Eff SEP 14 2009] (Auth: HRS §§ 231-3(9), 235-2.5(b), 231-10.6, 235-118) (Imp: HRS §§ 231-36.5)

3. Chapter 18-231, Hawaii Administrative Rules, is amended by adding a new temporary section 18-231-36.6-01T to read as follows:

"**§18-231-36.6-01-6662T Guidance; substantial understatements or misstatements of amounts; conformity to treasury regulations related to Internal Revenue Code section 6662.** (a) In administering the penalty set forth under section 231-36.6, HRS, relating to imposition of a penalty for substantial understatements or misstatements of amounts, the treasury regulations adopted under title 26, code of federal regulations, section 1.6662—4, shall be operative.

(b) The director may prescribe a list of positions that the director believes do not meet the substantial authority standard. Such list (and any revisions thereof) shall be published and made public pursuant to Tax Information Release.

(c) The director may adopt additional examples and other administrative guidance pursuant to Tax Information Release." [Eff SEP 14 2009] (Auth: HRS §§ 231-3(9), 235-2.5(b), 231-10.6, 235-118) (Imp: HRS §§ 231-36.6)

4. Chapter 18-231, Hawaii Administrative Rules, is amended by adding a new temporary section 18-231-36.7-01T to read as follows:

"**§18-231-36.7-01-6700T Guidance, promoting abusive tax shelters; conformity to treasury regulations related to Internal Revenue Code section 6700.** (a) In administering the penalty set forth under section 231-36.7, HRS, relating to imposition of a penalty for promoting abusive tax shelters, any proposed, temporary, or final treasury regulations providing guidance in

application of section 6700 of the Internal Revenue Code shall be operative.

(b) The director may adopt additional examples and other administrative guidance pursuant to Tax Information Release.

(c) The director may maintain a list of transactions considered by the department to be abusive tax shelters. This list shall be maintained by Tax Information Release and shall be updated from time to time, as is necessary.

(d) Safe harbor. A person who promotes a tax shelter that may or may not be considered abusive by the department will not be assessed the penalty under section 231-36.7, HRS, if the promoter first makes application with the department for a letter ruling pursuant to Tax Information Release 2009-1, and who thereafter receives a favorable ruling from the department. A ruling will not be considered a favorable ruling within the meaning of this safe harbor unless all partnership agreements, operating agreements, investment plan documents, and other relevant information discussing the organization of the plan are acknowledged in the ruling as having been disclosed and considered by the department in drawing its conclusion.

(d) Action to enjoin a tax shelter promoter. Section 231-36.7 (c), HRS, authorizes the director to seek an injunction from a court enjoining a tax shelter promoter from engaging in any conduct described under section 231-36.7 (a), HRS. A civil action to enjoin a tax shelter promoter shall be subject to the following procedures:

(1) A civil action to enjoin a tax shelter promoter shall be brought by the attorney general at the director's request.

(2) The civil action to enjoin a tax shelter promoter shall be based upon facts alleging the person is a tax shelter promoter, as defined in section 231-36.7 (a), HRS, and that person has engaged in any conduct that is prohibited under section 231-36.7 (a).

(3) The civil action shall be brought in the circuit court where the tax shelter promoter resides or has a principal place of business, at the election of the director.

(4) An injunction enjoining a tax shelter promoter shall be effective upon the issuance of a court order after a finding by the court that the person is a tax shelter promoter, as defined in section 231-36.7 (a), and has engaged in any conduct subject to a penalty under section 231-36.7 (b), and that injunctive relief is appropriate to prevent the recurrence of that conduct." [Eff SEP 14 2009] (Auth: HRS §§ 231-

3(9), 235-2.5(b), 231-10.6, 235-118) (Imp: HRS §§ 231-36.7)

5. Chapter 18-231, Hawaii Administrative Rules, is amended by adding a new temporary section 18-231-36.8-01T to read as follows:

"**§18-231-36.8 -01-6676T Guidance, erroneous claim for refund or credit; conformity to treasury regulations related Internal Revenue Code section 6676.** (a) In administering the penalty set forth under section 231-36.8, HRS, relating to imposition of a penalty for erroneous claims for refund or credit, any proposed, temporary, or final treasury regulations providing guidance in application of section 6676 of the Internal Revenue Code shall be operative.

(b) The director may adopt additional examples and other administrative guidance pursuant to Tax Information Release.

(c) Excessive amount. Section 231-36.8, HRS, assesses a penalty equal to twenty per cent of the claimed refund or credit amount found to be erroneous, which is called the "excessive amount." The excessive amount is the difference between the amount of refund or credit claimed for any taxable year and the amount of refund or credit allowable for the same taxable year.

(d) Section 18-231-36.8-01-6676(c), HAR, is illustrated as follows:

> **EXAMPLE:** Taxpayer made a return for the 2008 taxable year claiming $10,000 in refundable credit on its 2008 tax return. All of Taxpayer's income was offset by allowable operating losses for the same taxable year, which resulted in a credit refund claim calculation of $10,000. Upon audit, it was determined that Taxpayer was entitled to a $6,000 credit and $4,000 in claimed credit was disallowed. The department further assessed the erroneous refund penalty under section 231-36.8, HRS. The "excessive amount" for purposes of the penalty under section 231-36.8, HRS, is $4,000, which is the difference between the amount of credit that was claimed and the amount of credit allowable. The twenty per cent penalty will be applicable to the $4,000 base amount, which results in a penalty of $800.

(e) $400 minimum penalty. Section 231-36.8, HRS, provides an exclusion from the twenty per cent penalty where the penalty calculation results in an amount of less than $400. Therefore, where the excessive amount, which serves as the base for the

credit calculation, results in a penalty of less than $400, no penalty will be assessed. In dollar figures, where the excessive amount is less than $2,000 in claimed refund or credit, no penalty will be assessed pursuant to section 231-36.8, HRS. The $400 minimum penalty calculation does not take into account any interest accruable on the disallowed amount.

(f) Section 18-231-36.8-01-6676(e) is illustrated as follows:

> **EXAMPLE:** Assume the same facts as the Example in subsection (d), except that upon audit it was determined that the taxpayer was entitled to $9,000 in credit and was disallowed $1,000 in claimed credit. Assume further that there was no reasonable basis for the excessive $1,000 credit claim. In this case, the "excessive amount" for purposes of calculating the penalty under section 231-36.8, HRS, is $1,000. Applying the twenty per cent penalty to the $1,000 excessive base amount results in a penalty of $200. Pursuant to the express terms of section 231-36.8, HRS, no penalty will be assessed under these facts because the penalty is less than $400.

(g) Reasonable basis defense. Section 231-36.8, HRS, provides for a defense against the erroneous refund penalty where the taxpayer has a reasonable basis for claiming the credit or refund. The burden of proof is on the person claiming the position taken on the return had a reasonable basis.

The reasonable basis standard is higher than frivolous or not patently improper. The reasonable basis standard is considered a one-in-four, or greater, likelihood of success on the merits of the claim after a person knowledgeable in the tax law makes a reasonable analysis. The director may prescribe a list of positions that the director believes do not meet the reasonable basis standard. Such list (and any revisions thereof) shall be published and made public pursuant to Tax Information Release.

Reasonable basis expressly includes innocent mistakes related to the refund or credit claim, which are errors on a return due to inadvertence or mathematical mistakes.

(h) Section 18-231-36.8-01-6676(g) is illustrated as follows:

> **EXAMPLE 1:** XYZ Corporation conducted qualified research in Hawaii and further incurred qualified research expenses that generated a credit claim under section 235-110.91, HRS. In making its credit calculation, XYZ Corporation inadvertently added a line item invoice for

research expenses twice, thus creating a larger base amount for determining its credit. Upon audit, the double calculation was discovered and the second claim for the same cost was disallowed. Under the facts of this example, XYZ Corporation's excessive amount for purposes of the penalty under section 231-36.8, HRS, was due to an inadvertent calculation error and therefore had a reasonable basis in making its excessive claim. The claim for the excessive amount is rightfully disallowed; however, no penalty under section 231-36.8, HRS, should be assessed in this circumstance.

EXAMPLE 2: Assume the same facts as in Example 1; however rather than an inadvertent calculating error, XYZ Corporation knowingly included travel expenses unrelated to the qualified research activity, which were charged to a particular research project journal account for accounting purposes and knowingly included in the research tax credit claim. Rather than remove the disqualified expenditure from the credit claim, XYZ Corporation made the claim for the whole project account knowing the travel costs did not qualify. Upon audit, the claim for the travel expenses unrelated to qualified research activity was disallowed. Upon inquiry, XYZ Corporation said the disqualified travel was included out of convenience in its accounting practice. Under the facts of this example, XYZ Corporation's excessive amount included a claim for credit for which there was no basis. XYZ Corporation knowingly included the amount, which was unrelated to qualified research. Such claims are not allowed pursuant to a plain reading of section 231-110.91, HRS, which eliminates any reasonable basis for making the claim. Because XYZ Corporation's excessive amount had no reasonable basis under these facts, a penalty under section 231-36.8, HRS, would be warranted and is assessable in the discretion of the auditor; provided the director approves of the assessment pursuant to sections 231-36.8 and 18-231-10.6-01(h)." [Eff SEP 14 2009] (Auth: HRS §§ 231-3(9), 235-2.5(b), 231-10.6, 235-118) (Imp: HRS §§ 231-36.8)

6. New material is underscored.

7. Additions to update source notes to reflect these amendments are not underscored.

8. These temporary amendments to chapter 18-231, Hawaii Administrative Rules, shall take effect seven days after public notice is issued.

I certify that the foregoing are copies of the rules, drafted in the Ramseyer format, pursuant to the requirements of section 231-10.6, HRS. These temporary amendments are effective on SEP 14, 2009. These temporary amendments are effective for eighteen months from their effective date.

Director
Department of Taxation