

SCR 166

LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR



KURT KAWAFUCHI
DIRECTOR OF TAXATION

SANDRA L. YAHIRO
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

SENATE COMMITTEE ON ENERGY & ENVIRONMENT

TESTIMONY REGARDING SCR 166/SR 115

REQUESTING THE AUDITOR TO CONDUCT A MANAGEMENT AUDIT OF THE ENVIRONMENTAL RESPONSE TAX

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: APRIL 2, 2009

TIME: 3:15PM

ROOM: 225

This resolution requests the Auditor to conduct a management audit on the Department of Taxation's administration of the environmental response tax.

The Department of Taxation (Department) **opposes** this resolution for the reasons set forth below and **requests that it be held; or in the alternative, amended to request the Department to audit the taxpayers** that are required to voluntarily report these taxes.

A MANAGEMENT AUDIT OF THE DEPARTMENT WILL NOT ANSWER THE QUESTIONS RAISED IN THIS RESOLUTION

What this resolution fails to take into account is the nature of the Hawaii tax system itself. The tax system is based upon each taxpayer being responsible for initially assessing their own taxes and then reporting enough information to the Department, with any payments, so that audits may be conducted as necessary to verify the accuracy of all taxpayers' understanding of the Hawaii tax laws. This self-assessment system is an efficient use of State resources; and is the system employed by the federal government and most nations.

The Department does not predetermine each and every taxpayer's liability and then pursue collection. Such a system would consume tremendous amounts of time, effort, and resources, and it is highly unlikely that such an intrusive system would result in additional revenue. In fact, the cost of such an effort would probably result in less revenue to the State.

A management audit of the Department's administration and collection of the fuel tax will not explain the reason for the difference identified in the environmental response tax collections and the license tax collections. The explanation will either come from an audit of all fuel tax taxpayers or

from a review of the structural and functional differences between the two taxes. Reviewing how the Department receives tax returns, accounts for checks, gathers information from the returns, reports the information, enforces compliance, and disburses the revenue to the appropriate special fund will not explain the gallon difference calculated by the Senator offering this resolution.

RESOLUTION IS BASED UPON FAULTY ASSUMPTIONS

The Resolution incorrectly assumes or states provisions of the law or their interpretation. First, the Resolution states that federal law does not exempt the environmental response tax for sales in foreign trade zones and that "our State's law is supposedly mirrored after the federal law." Without question, Hawaii's foreign trade zone law clearly provides an exemption for certain sales made in the foreign trade zone. Hawaii's foreign trade zone law exempts all sales in the zone from Chapter 243, in which the environmental response tax is contained.

§212-8 Exemption from taxes. Notwithstanding any law to the contrary, sales of all products...which are admitted into a foreign-trade zone...shall be exempt from those taxes imposed under chapters 237, 238, 243, 244D, and 245.

Based upon this analysis, a simple explanation for the difference in data is that the sales in the foreign trade zone likely contribute to the difference in numbers. Again, because the foreign trade zone laws exempt sales from Chapter 243 entirely, and the environmental response tax is contained therein, these sales are not contributing to this tax.

Second, the Resolution is inaccurate in its assumption that each barrel reported contains 42 gallons of petroleum product. The environmental response tax is calculated as \$.05/barrel **or fractional part of a barrel**. A barrel reported by the taxpayer may or may not contain 42 gallons. The report from which the numbers appear to be taken does provide a definition of barrel as 42 gallons; however, the information provided by the taxpayer does not break down partial barrels; in other words, a partial barrel is treated as a full barrel on the tax form. It is not clear what purpose it would serve to require taxpayers to report partial barrels when they have to pay the same as a full barrel. In fact, such an unnecessary reporting requirement would likely cause confusion that the entire \$.05 is due on a partial barrel.

Third, the Resolution assumes that the license tax and the environmental response tax function equivalently, so that tax paid on a barrel of petroleum product sold by distributor to a retail dealer or end user can be translated into license taxes levied against distributors on gallons of liquid fuel that they refine, manufacture, produce, compound, import, or use. Also, the timing of the two tax payments need not match up. It is not a logical necessity that the two taxes can be calculated from one another as they do not have the same tax triggers. The two taxes function differently.

Fourth, the Resolution assumes that Department should prevent distributors from reporting too much tax. The environmental response tax is only \$.05/barrel, or \$.05 for every 42 gallons of fuel. It would not surprise the Department if the distributors subject to the tax simplified their tax accounting by paying the tax on every barrel as it is imported, rather than waiting to pay the tax when the barrel is sold to an end user or retail dealer. In the grand scheme, \$.05/barrel may be so insignificant, that the distributor may easily incorporate it into the price it charges end users or retail

dealers, even if the sale to the particular user is exempt from the fuel taxes. If the tax is not separately stated, there is no way to determine whether the price of the sold petroleum product contains the cost to the distributor of just paying the tax. And it is highly unlikely that a distributor would go to the trouble of developing a system to keep track of the environmental response tax at its current rate. This is conjecture on the part of the Department, but it demonstrates that an audit of the Department will not uncover this type of information. If a taxpayer chooses to pay more than it is required by law, there is no duty on the part of the State to reject the overpayment. It would make little sense to expend limited Department resources to force distributors to adopt a more complicated accounting approach when they are not underpaying the tax.

Fifth, although the environmental response tax is not charged whenever a sale is exempt pursuant to section 243-7, it will be charged when it is only the license tax that is refundable or not collected pursuant to section 243-4(c) or (d).

Finally, a "discrepancy" between the environmental response tax collections and license tax collections has existed since the environmental response tax was enacted starting with Fiscal Year 1994. The Resolution uses calendar year information based upon on-line reports of the Department, but that information only goes back to 1997, so to demonstrate the consistency of the relationship back to enactment, the information given here is by fiscal year:

| | Gallons reported (License Tax) | Gallons reported (Environmental Tax) | As if sold X gallons per barrel |
|---------|-----------------------------------|---|------------------------------------|
| FY 1994 | 1,234,733,000 | 29,394,000 | 42.01 Gal/barrel |
| FY 1995 | 1,239,744,000 | 39,056,000 | 31.74 Gal/barrel |
| FY 1996 | 1,282,359,000 | 33,387,000 | 38.41 Gal/barrel |
| FY 1997 | 993,175,000 | 35,624,000 | 27.88 Gal/barrel |
| FY 1998 | 936,963,000 | 33,928,000 | 27.62 Gal/barrel |
| FY 1999 | 965,133,000 | 35,302,000 | 27.34 Gal/barrel |
| FY 2000 | 1,036,520,000 | 34,287,000 | 30.23 Gal/barrel |
| FY 2001 | 1,007,766,000 | 36,535,000 | 27.58 Gal/barrel |
| FY 2002 | 981,522,000 | 35,676,000 | 27.51 Gal/barrel |
| FY 2003 | 903,152,000 | 31,242,000 | 28.91 Gal/barrel |
| FY 2004 | 926,668,000 | 32,553,000 | 28.47 Gal/barrel |
| FY 2005 | 1,045,337,000 | 37,312,000 | 28.02 Gal/barrel |
| FY 2006 | 944,594,000 | 36,158,000 | 26.12 Gal/barrel |
| FY 2007 | 875,530,000 | 34,826,000 | 25.14 Gal/barrel |
| FY 2008 | 997,237,000 | 33,909,000 | 29.41 Gal/barrel |
| CY 2008 | 920,041,958 | 32,777,477 | 28.07 Gal/barrel |

As to the first fiscal year, as it was the first year the tax was imposed, it would not surprise the Department that the distributors simply paid environmental response tax based upon what was sold during the fiscal year. As discussed above, however, it might be easier for the distributors to account for the environmental response tax as it comes in rather than as it is sold; if so, a discrepancy would appear in the first year such an approach was taken.

RATHER THAN AUDIT THE DEPARTMENT; REQUEST THE DEPARTMENT TO AUDIT DISTRIBUTORS WHO REPORT THE INFORMATION—If it is important to the Legislature that an answer be found, it would make more sense to request the Department to determine the reason for the discrepancy through its audit function rather than request the Auditor to examine what the Department does with the taxes and information it collects from the fuel distributors. However, such an endeavor would require the Department to expend limited and valuable resources to this project, resources that may be more usefully expended on other projects.

Respectfully, the Department requests that this Committee **hold the resolution**; or, in the alternative, amend it to request the Department to audit the producers of liquid fuel for their compliance in reporting the environmental response tax.