No. CAAP-16-0000462

IN THE INTERMEDIATE COURT OF APPEALS

STATE OF HAWAI`I

TAX FOUNDATION OF HAWAI`I, a Hawai`i non-profit corporation, on behalf of itself and those similarly situated,

Plaintiff/Appellant,

vs.

STATE OF HAWAI`I,

Defendant/Appellee.

Civil No. 15-1-2020-10

APPEAL FROM THE:

(1) FINAL JUDGMENT FILED JUNE 1, 2016 AND (2) ORDER GRANTING DEFENDANT'S MOTION TO DISMISS COMPLAINT FILED ON OCTOBER 21, 2015 (FILED ON NOVEMBER 10, 2016), FILED MAY 16, 2016

FIRST CIRCUIT COURT, STATE OF HAWAII

The Honorable Edwin C. Nacino, Judge

PLAINTIFF/APPELLANT TAX FOUNDATION OF HAWAI`I'S REPLY BRIEF

CERTIFICATE OF SERVICE

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PLAINTIFF/APPELLANT TAX FOUNDATION OF HAWAI`I'S REPLY BRIEF

I. INTRODUCTION

The State's Answering Brief is long and dense, but short on substance. It fails to establish good cause for affirmance for four reasons. First, this is not a controversy about tax; it is a controversy about the misallocation of tax proceeds collected by the State and diverted from the City & County of Honolulu (the "City"). As this court reasoned in *Hawaii Insurers Council v. Lingle*, 117 Hawai`i 454, 184 P.2d 769 (Ct. App. 2008) ("*Insurers Council I*"), a case alleging unlawful diversion of monies is not barred by the "tax controversy" language in HRS § 632-1; this case is no different. The State argues this case should have been filed in the Tax Appeal Court, but that is a red herring because the Tax Foundation is not disputing its obligation to pay the GET Surcharge or the amount due. As explained in HRS § 232-2: "[n]o taxpayer shall been aggrieved by an assessment to the extent that it is in accordance with the taxpayer's return" and the Tax Appeal Court's jurisdiction "is limited to the amount of . . . taxes in dispute between the taxpayer on one hand and the assessor on the other." HRS § 232-13. The Tax Court can decide only whether and to what extent the money in dispute is a lawful government realization [*see* HRS §232-24]; as a court of limited jurisdiction to decide whether, or to what extent, the State unlawfully pocketed money that Honolulu raised under its tax surcharge ordinance. But that is the precised question presented here.

Second, the State is wrong in claiming the Foundation lacks standing. Governments do not pay taxes; taxpayers do. Therefore, the Foundation, as a taxpayer, continuously injured by the State diverting money away from the Honolulu Authority for Rapid Transportation project ("HART"), which causes over-collection of the amounts needed to sustain HART. A favorable decision would provide more support to HART for the benefit of the City—to the relief of the affected taxpayers. The State has created a vicious cycle: the more it

diverts, the less the City receives, the longer the GET surcharge is needed; the more the taxpayers must pay.

Third, the State's interpretation of HRS § 248-2.6 is illogical. In effect, it contends (wrongly) that it can disregard most of the statute, or that it may reap a windfall, namely every penny of the diverted 10% deduction, from its own inaction in failing to calculate the costs of collection and administration. Even if those costs had not been calculated (they were), it is not an impossible task and no good faith approximation could support retention of the staggering amounts here involved, namely amounts at or above the total cost of running DOTAX.

Finally, if necessary, this Court should rule that the Circuit Court abused its discretion by denying the Foundation's oral motion to amend its complaint for the first time. Under HRCP 15, the refusal to allow one chance to amend is proper **only** if amending was either unnecessary or futile. Since resolving that question requires attention to the merits, and since this is a simple dispute on undisputed facts (albeit with big financial consequences); the parties and the public will be ill-served by a remand of this important dispute when the merits are ripe for decision—not just an assessment of alleged futility.

II. ARGUMENT

A. The Circuit Court Had Jurisdiction Pursuant to the Decision in *Insurers Council I.*

The State would have this Court ignore its own analysis regarding prohibitions on declaratory judgments with respect to "tax refund controversies" set forth in *Insurers Council I* and declare a dispute over the inter-government diversion of tax revenue is entirely non-reviewable. *See* Answering Brief (cited as "A.B.") at 6-12. In *Insurers Council I*, the insurance trade association sued the State challenging the transfer of assessments paid by insurers under HRS § 431:2-215 to the State general fund. There the State, again, specifically argued that there was no jurisdiction, in part, because the

lawsuit violated the prohibition against declaratory relief actions regarding taxes under HRS § 632-1. This Court rejected that argument. It held that the prohibition against actions regarding taxes under HRS § 632-1 did not apply because plaintiff was not attempting to prohibit the State from assessing and collecting taxes. *Insurers Council I*, 117 Hawai`i at 462, 184 P.2d at 777, *aff'd in part and rev'd in part on other grounds*, 120 Hawai`i 51, 201 P.3d 564 (2008). Although it reversed part of the ICA's ruling, the Supreme Court found no need to reach the HRS § 632-1 issue. It did, however, order return of the raided monies, making it clear that the courts have power to remedy the misdirection of funds. .

Here, the State asks this Court to follow "persuasive guidance" from federal courts and *Grace Business Development Corp. v. Kamikawa,* 92 Hawai`i 608, 994 P.2d 540 (2000) ("*Grace Business*"). A.B. at 8. But, *Grace Business* is irrelevant. In that case, the plaintiff paid GET and transient accommodations tax **under protest** and then sought a declaratory ruling to contest its liability for these taxes. The Hawai`i Supreme Court found the circuit court could not grant declaratory relief because the dispute would affect the ability of the executive branch to "assess and collect taxes . . . without judicial interference." *Id.* at 613, 994 P.2d at 545. This case has nothing to do with "assessing and collecting" the County Surcharge; it only concerns the post-collection disposition of the taxes. The federal cases are similarly irrelevant.[1]

The Foundation is not seeking any ruling or relief as to its liability for GET or the County Surcharge. It does not contest either that it must pay GET and the County Surcharge, or the amount of GET it has already paid or will pay in the future. Instead, the Foundation sought (and seeks) an injunction

[1] None of the federal cases has any relevance. They all involved overly clever taxpayers trying to find ways to obtain rulings that would affect their own tax liabilities. As the Defendants concede (A.B. at 8), the federal restriction on declaratory relief actions extends to "any activities that are intended to or may culminate in the assessment or collection of taxes…." This case only relates to post-collection mishandling of the taxes.

compelling the State to turn over to Honolulu all amounts improperly kept by the State after it has calculated and retained the actual cost of assessing, collecting and disposing of the County Surcharge. [2]

B. Plaintiff Has Standing

The State asserts that the Foundation does not have standing because it allegedly cannot satisfy the "injury in fact" test required for standing under *Mottl v. Miyahira*, 95 Hawai`i 381, 389 (2001). A.B. at 18. The State argues that it is really the City "that has the 'injury in fact' and the legal standing to sue, not Plaintiff" [*id.*] because the Foundation is seeking for the State to disgorge the funds it has illegally kept and transfer them to the City. *Id.* The fatal problem in this argument is that citizens pay taxes, not governments. The Foundation has paid the Surcharge and is vitally invested in its proper use considering it will be continually taxed for the same until the rail project is finished. The Foundation has fully satisfied this requirement.[3]

The State also asserts that the Foundation does not have standing because a favorable ruling cannot provide relief for its injury. A.B. at 19. The State is wrong again. While the State argues that "[b]ecause State agencies are not currently equipped to perform the cost accounting that Plaintiff's remedy requires, Plaintiff's remedy is not feasible," [*id.* at 19-20], the record does not support this assertion. What the record does support is that the State has not

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[2] The State this point argues is "meritless" because the relief sought by the Foundation "may ultimately culminate in the 'collection' of the State's portion of the taxes being obstructed." A.B. at 8. In fact, as HRS §248-2.6(a) makes clear, the State collects and deposits **everything ("all county surcharges").** Then, it disburses the County's share; as §248-2.6(d) explains, the State Director of Finance must "pay **the remaining balance**" to the County. It is only that last step that will be affected by this lawsuit if the Foundation's claims are valid.

[3] The Foundation explicitly disclaimed its refund remedy of its own taxes, which was one of the alternative remedies mentioned in the prayer in the Complaint. ROA 1:112. *See also* Ct. Tr. 21:10-19. Therefore, any assertion that the Foundation's standing is more appropriate in the Tax Appeal Court is false since it does not seek a refund of its own GET payments.

even bothered to comply with the law. If the State does not have a cost accounting system in place to allow it to comply with the requirements of HRS § 248-2.6, [4] it has only itself to blame.

The State's inaction does not prove that the State could **not** perform such calculations or that such cost accounting systems do not exist. Moreover, the State's assertion that it "would need additional resources to establish a cost accounting system where none currently [exists], and there is no indication that the Legislature will provide such resources" [A.B. at 20], is completely false. HRS §248-2.6 expressly authorizes the State to deduct all "costs of assessment, collection and disposition," and that includes "all costs, direct or indirect, that are deemed necessary and proper to effectively administer" the law. Since the State has kept over $177 million, it surely has enough funding to administer the allocation process. The State also has not presented any credible reason why the Foundation's injury cannot be remedied by the implementation of proper cost accounting systems. *See Office of Hawaiian Affairs v. State,* 110 Hawai`i 338, 357, 133 P.3d 767, 786 (2006) ("[I]f there is a continuing violation of an ongoing breach resulting from a past action, then prospective relief, i.e., an injunction to stop the continuing violation, is available.") Injunctive relief is an appropriate remedy here since even imposition of cost accounting systems would alleviate the continuing economic burden placed on the Foundation and the Honolulu Taxpayers.

At minimum, the Foundation should obtain injunctive relief that requires the State (1) calculate the costs incurred in assessing collecting and disposing of the Surcharge, and (2) for past distributions, disgorge and pay Honolulu all amounts in excess of its costs that the State has kept, and (3) for future distributions, keep from Honolulu only its costs incurred in assessing, collecting and disposing of the Surcharge.

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[4] This claim is doubtful, if not downright false, given the state's prior reports to the legislature on this issue. ROA 1:144-49. And, if the state is not "currently equipped," it is only because it is flouting the law.

C. The State Misreads HRS § 246-2.8 by Disregarding Motion of the Statute[5]

The State argues that its interpretation does not render subsections (b), (c), and (d) superfluous because they "still accomplish *other* things essential to the statute." A.B. at 23. This is not true. The State's reading of (a) that it "**shall** deduct" without regard to the actual words used in (b)-(d) literally makes the remaining sections irrelevant. This is the absurd interpretation.

In an attempt to address subsection (c), the State argues that subsection (c) provides "a very expansive justification for the ten percent reimbursement." A.B. at 23. Subsection (c) does nothing of the sort unless the enumerated items, fairly calculated, total 10% of the surcharge. If they fall short of that percentage, then nothing entitles the State to claim more.

In contrast, the Foundation's analysis of the entire statute is the proper statutory interpretation. The plain and unambiguous language of HRS §248-2.6 instructs the State in subsection (a) to initially deduct 10% of the gross proceeds of the County Surcharge "to **reimburse** the State for the costs of assessment, collection, and disposition of the county surcharge on State tax incurred by the State." In subsection (b), the statute requires that the "amounts deducted for costs of assessment, collection, and disposition of the county surcharge shall be withheld from payment to the counties by the State." Subsection (c) defines which costs may be deducted. Subsection (d) then provides that "after the deducting and withholding of the costs under subsections (a) and (b), the director of finance shall pay the remaining balance" to the county.

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[5] The State argues that this Court should not seek remedy from this Court in the form of a ruling on the merits. However, the Foundation asserts that pursuant to HRE 201, this Court can and should take judicial notice of HART's enormous costs and the fact that ending the diversion of tens of millions of dollars (and disgorging past amounts) would be of enormous benefit to Oahu taxpayers and HART.

D. The State's Interpretation is Not Consistent With the Legislative Intent

1. The Purpose of Act 247 Was to Assist Counties in Raising Funds for County Specific Needs

The primary purpose of HRS §248-2.6 was to assist Honolulu in raising funds for its mass transit rail system. To that end, the Legislature granted Honolulu (as well as other counties) taxing authority to raise capital to fund public transportation improvements. Since the Surcharge was added to a State tax (GET), the Legislature reasonably concluded that it was more efficient for DOTAX and Budget & Finance to collect, assess, and administer the Surcharge. The State would be reimbursed for the additional costs associated with the Surcharge.

Honolulu exercised this taxing authority by imposing the Surcharge to fund its ambitious rail transit system. The State can point to no law or testimony that the purpose of the statute was, instead, simply to increase the monies into the State's general fund to be used for statewide programs. And, if that were indeed the purpose of the law, then our federal and state constitutions should be consulted, as discussed below.

2. The State Fails to Show the Rational Basis for the 10% Deduction to a Legitimate State Interest

In order for this statute to survive Equal Protection scrutiny, a rational basis for the obvious discrimination against the Honolulu taxpayers – the *only* taxpayers currently holstering the entire 10% deduction – must exist. In arguing its rational basis, the State admits that the 10% retained is more akin to an administrative fee or even "compensat[ion to] the State with the funds from the ten percent deduction" for potential disruptions caused by the construction of Honolulu's rail project. A.B. at 29.[6] The State's position is, therefore, that (1) it is not required to calculate the costs despite the plain

[6] A notion which certainly is not supported by *any* interpretation of "costs" or "reimbursement" used in HRS § 246-2.6.

language to do so from subsection (b) and (c); **and** (2) the Legislature intended for the 10% deduction to have no relation at all to the amount of actual costs association with the administration of the County Surcharge. The 10% deduction then is merely the price – or "fee" – that the Foundation and the Honolulu Taxpayers must pay for electing to implement the Surcharge. This analysis renders the 10% deduction a tax, not an administration fee. *State v. Medeiros,* 89 Hawai`i 361, 973 P.2d 736 (1999).

The State also argues that because the 10% deduction, at least, pays – or rather *paid* – for the costs which have indisputably occurred in association with the administration of the County Surcharge that it has met its burden to show the rational relationship to a legitimate State interest in collecting the funds *only* from the Honolulu Taxpayers. A.B. at 27-29. It has not.

The proper approach to this is, again, explained by the Supreme Court in *Hawai`i Insurers Council v. Lingle*, 120 Hawai`i 51, 201 P.3d 564 (2008) ("*Insurers Council II*"). There, the Supreme Court distinguished "fees" from "taxes" and explained that the former must meet a three-part test: the charge must be (1) applied to the direct beneficiary of a particular service; (2) allocated directly to defraying the costs of providing the service, and (3) reasonably proportionate to the benefit received.[7] On this basis, the Court upheld the general scheme under which insurers were required to pay fees to the DCCA, but it invalidated the raid of $3.5 million from the DCCA insurance division's compliance resolution fund and transfer to the general fund. Those transfers were found to be "taxes," which were imposed in violation of the separation of powers doctrine because they exceeded the amount that ultimately went to support the overhead of the DCCA and the Department of Budget and Finance.

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[7] The Supreme Court distinguished "user" fees from "regulatory fees," which are based upon "the police power to regulate particular businesses or activities." *Hawaii Insurance Council II,* 120 Hawai`i at 60, 201 P.3d at 573. Obviously, this case involves, at best for the State, only a user fee. A point which the State conveniently omits from its analysis.

So, the question, here, becomes whether there is any basis on which the State can, by refusing to calculate the costs of assessing, collecting and disposing of the surcharge, take the entire 10% and put it into the general fund, when the actual costs are demonstrably lower (as shown by comparing the total budget of the Department of Taxation for **all** its work to the amount withheld from the Oahu Surcharge). This is exactly the kind of overreaching condemned by the Supreme Court in *Insurers Council II.* Honolulu imposed a surcharge tax by ordinance. The tax burdens Oahu taxpayers and is supposed to be used for a rail system that would benefit Oahu taxpayers. Honolulu is entitled to its money less actual costs.

But, the tax in this case also violates the equal protection clause, for the State is imposing an added GET burden on the taxpayers of Oahu—only—for no rational reason. The fact that Oahu is building a transit system is no cause for the State to a substantial part of the tax revenue under the guise of taking funds for "assessing, collecting and disposing" of the Surcharge. While the State is surely entitled to recover its costs, it is not entitled gouge Oahu taxpayers. This is not a case like *Insurers Council II*, where the tax covered only "a substantial portion of the administrative costs" of running the "insurance division and its supporting offices and divisions." There was, therefore, a rational basis for imposing "the entire burden" upon the industry. Here, in contrast, the amounts diverted from the Surcharge are vastly more than can be justified as costs. As a result, those who pay the Surcharge are paying more GET to the State than those who are not. That discrimination can be corrected only by turning the amounts in excess of the State's costs over to Honolulu so those monies can be used for constructing the rail project.

Hasegawa v. Maui Pineapple Co., 52 Haw. 327, 475 P.2d 679 (1970) teaches us that even under a rational basis review, "[t]he cost of a proper state function conducted for the public benefit cannot be arbitrarily charged to one class in the society." That the same Hobson's choice – enact a surcharge and let the State steal 10% or don't enact one at all – available to the other counties should not change the analysis. Whether the "one class in the society" is not

just Honolulu but is expanded to "all counties who have adopted the surcharge," the principle is still violated if the State is allowed to take a flat 10% deduction without regard to actual cost.

E. The Circuit Court Erred by Not Allowing the Foundation to Amend its Complaint and Such Amendment Would Not be Futile

The State ignores that it was *per se* error to refuse at least one chance to amend the pleadings. *See Lopez v. Smith*, 2013 F.3d 1122 (9th Cir. 2000) (*en banc*) ("a district court should grant leave to amend **even if no request to amend the pleading was made**, **unless it determines that the pleading could not possibly be cured by the allegation of other facts**.") (internal quotations omitted; emphasis added.)

Since, as shown above, an amendment to resolve any alleged ambiguity would not have been futile, if any amendment was needed (it wasn't), the denial was *per se* error. In truth, the issues were properly framed, no material facts disputed, and Judge Nacino should have reached and decided on the merits in the Foundation's favor. This court should do the same without delay.

III. CONCLUSION

For these reasons and the reasons set forth in its Opening Brief and above, the Circuit Court's ruling should be reversed; the merits determined in the Foundation's favor; and the matter remanded to implement an injunctive remedy compelling the State to refund the amounts in excess of the actual "costs of assessment, collection and disposition" (including the costs of creating a system for making the required calculations).

DATED: Honolulu, Hawai`i, December 9, 2016.

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No. CAAP-16-0000462

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CERTIFICATE OF SERVICE

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