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IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

In re DEPARTMENT OF TAXATION, ADMINSTRATIVE DIRECTIVE NO. 2021-01. TAX FOUNDATION OF HAWAI'I, a Hawai'i nonprofit corporation, Plaintiff, vs. DEPARTMENT OF TAXATION, STATE OF HAWAI'I, Defendant.	CIVIL NO. 1CCV-24-0000661 DEFENDANT DEPARTMENT OF TAXATION, STATE OF HAWAII'S MEMORANDUM IN OPPOSITION TO PLAINTIFF'S MOTION FOR SUMMARY JUDGMENT FILED ON JUNE 19, 2024; CERTIFICATE OF SERVICE HEARING: Date: July 10, 2024 Time: 10:30 a.m. Judge: The Honorable Karin L. Holma

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DEFENDANT DEPARTMENT OF TAXATION, STATE OF HAWAII'S
MEMORANDUM IN OPPOSITION TO PLAINTIFF'S
MOTION FOR SUMMARY JUDGMENT FILED ON JUNE 19, 2024

I. INTRODUCTION

Plaintiff Tax Foundation of Hawaii ("Plaintiff), through this instant action, seeks to restrain the State of Hawaii, Department of Taxation's ("Department") ability to assess and collect taxes. Plaintiff's Complaint seeks to have this Court issue a Declaratory Judgment with respect to an administrative directive issued by the Director of Taxation ("Director") which provides guidance regarding the assessment of penalties. However, Declaratory Judgment is not an available remedy for controversies related to taxes. Plaintiff's action interferes with the Director's assessments and collection of taxes. As such, this matter falls squarely within statutory prohibitions against this Court's jurisdiction to adjudicate controversies involving taxes. Moreover, as Plaintiff fails to provide any facts supporting its assertion that the Administrative Directive is a rule, its assertion that the Department was required to engage in rulemaking pursuant to the Hawaii Administrative Procedures Act fails. Plaintiff's claims are also non-justiciable because Plaintiff lacks standing. It is for these reasons; Plaintiff's Motion for Summary Judgment ("Plaintiff's MSJ") should be denied.

II. BACKGROUND

In response to a Uniform Information Practices Act, chapter 92F, Hawaii Revised Statutes ("HRS"), request from the Plaintiff, the Department emailed a copy of Administrative Directive No. 2021-1 (the "Administrative Directive") to Plaintiff. See Plaintiff's MSJ, Mem. in Supp. at 1. The Administrative Directive was dated April 27, 2021 and contained the words

"FOR INTERNAL USE ONLY." See Plaintiff's MSJ, Ex. 1. On May 20, 2024, Plaintiff filed the Complaint in the instant case, challenging certain portions of the Administrative Directive.

III. LEGAL STANDARD

Summary judgment is a drastic remedy. GECC Financial Corp. v. Jaffarian, 79 Hawaii 516, 521, 904 P.2d 530, 535 (App. 1995), *modified on other grounds*, 80 Hawaii 118, 905 P.2d 624 (1995). To avoid improperly depriving a party to a lawsuit of the right to a trial on disputed factual issues, summary judgment must be "cautiously invoked." Id. Summary judgment should only be granted if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. Id *citing* HRCP Rule 56(c).

It is well-settled that the party moving for summary judgment has the burden "to show the absence of any genuine issue as to all material facts, which, under applicable principles of substantive law, entitles the moving party to judgment as a matter of law." Alexander & Baldwin, Inc. v. Silva, 124 Haw. 476, 484, 248 P.3d 1207, 1215 (App. 2011). That burden has two components. Id. First, the moving party has the burden of producing support for its claim that: (1) no genuine issue of material facts exists with respect to the essential elements of the claim or defense which the motion seeks to establish or which the motion questions; and (2) based on the undisputed facts, it is entitled to summary judgment as a matter of law. Id. at 484-485, 248 P.3d at 1215-1216. Only when the moving party satisfies its initial burden of production does the burden shift to the non-moving party to respond to the motion for summary judgment and demonstrate specific facts, as opposed to general allegations, that present a genuine issue worthy of trial. Id. at 485, 248 P.3d at 1216. Second, the moving party bears the ultimate burden of persuasion. Id. This burden always remains with the moving party and

requires the moving party to convince the court that no genuine issue of material fact exists and that the moving party is entitled to summary judgment as a matter of law. Id. Finally, the Court must view all of the evidence and the inferences drawn therefrom in the light most favorable to the non-moving party. In re Trust Created Under Will Dated Nov. 15, 1917 of Cunha, 104 Haw. 267, 270, 88 P.3d 202, 205 (2004).

IV. ARGUMENT

A. Declaratory Judgment is Not Available to the Plaintiff In This Controversy With Respect to Taxes.

1. Declaratory Relief Would Interfere with the Department's Ability to Assess or Collect Taxes.

Plaintiff seeks a declaration that the Administrative Directive is invalid. However, such a declaration is not permitted pursuant to HRS § 632-1. Section 632-1, HRS specifically provides:

> (a) In cases of actual controversy, courts or record, within the scope of their respective jurisdictions, shall have power to make binding adjudications of rights, whether or not consequential relief is, or at the time could be, claimed, and no action or proceeding shall be open to objection on the ground that a judgment or order merely declaratory of right is prayed for; *provided that declaratory relief may not be obtained . . . in any controversy with respect to taxes . . .*. (emphasis added).

To determine if a matter is a "controversy with respect to taxes," the relevant inquiry is the interference with the government's ability to assess or collect taxes. See Tax Foundation of Hawaii v. State, 144 Hawaii 175, 187, 439 P.3d 127, 139 (2019) ("Declaratory relief may be obtained in tax matters under HRS § 632-1 where such relief does not interfere with the assessment or collection of taxes"); Ocean Resort Villas Vacation Owners Ass'n v. Cnty of Maui, 147 Hawaii 544, 556, 465 P. 3d 991, 1003 (2020) (if declaratory relief interferes with the assessment or collection of taxes, it was a "controversy with respect to taxes for which

declaratory relief under HRS § 632-1 is not allowed."). The basis for HRS § 632-1's prohibition against declaratory relief in tax matters exists, like in the federal Declaratory Judgment Act,[1] "to permit the government to assess and collect taxes alleged to be due it without judicial interference." Tax Foundation, 144 Hawaii at 187, 465 P.3d at 139 (citations omitted). Moreover, HRS § 632-1(b), requires that "where a statute provides a special form of remedy for a specific type of case, that statutory remedy shall be followed."

Here, there is no question that the relief requested by the Plaintiff is prohibited under HRS § 632-1(a). Section 231-39, HRS, titled "additions to taxes for noncompliance or evasion; interest on underpayments and overpayments" applies to "every tax or revenue law of the State that provides for the filing with the director of taxation a return or statement of the tax or the amount taxable." Further, penalties for the underpayment of taxes "shall be added to and become a part of the tax imposed by such tax or revenue law, and collected as such." HRS § 231-39(b). By challenging the Department's ability to assess and determine penalties, this action directly interferes with the Department's ability to assess and collect unpaid taxes in an expeditious manner. Unlike in Tax Foundation, where the Court held challenges to the 'administration and allocation" of a tax surcharge *after* it was assessed and collected did not constitute a controversy with respect to taxes, the action here seeks to impede the Department's ability to assess tax and collect tax penalties prior to collection. See 144 Hawaii at 188, 439 P.3d at 140. In this way, the requested relief by Plaintiff directly affects the Department's ability to assess and collect taxes, and therefore is barred by HRS § 632-1.

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[1] 28 U.S.C. § 2201.

2. The Assessments of HRS § 231-39(b)(2)(A) Penalties Should Be Determined In Tax Appeal Court.

Section 232-13, HRS, provides that the Tax Appeal Court "shall determine all questions of fact and all questions of law, including constitutional questions involved in the appeal," including "the amount of valuation or taxes, as the case may be, in dispute as shown on the one hand by the amount claimed by the taxpayer or county and on the other hand by the amount of the assessment,. . .." As such jurisdiction over this case undoubtedly belongs in Tax Appeal Court. Plaintiff's concern that a taxpayer would not otherwise be able to identify the basis of the penalty without this Court's intervention is simply baseless. See Plaintiff's MSJ, Mem. in. Supp. at 5. Plaintiff has not demonstrated that taxpayers are unable to receive information from the Department regarding the basis of any assessment. Similarly, Plaintiff has not shown that Taxpayers are precluded from examining audit records, receiving explanations for assessments, receiving clarification or objecting to the assessments, or requesting a meeting with the Department to discuss the assessments. And if a taxpayer disagrees with the Department's position on the basis for the assessment, the taxpayer can exercise its statutory remedy to appeal the assessment of the additional tax to Tax Appeal Court, just as the taxpayer appealed the Notice of Final Assessment attached as Exhibit 4 to the Tax Appeal Court.[2] Any lingering confusion regarding the basis of the penalty in the assessment can then be fleshed out during discovery and appropriately adjudicated by the Tax Appeal Court.

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[2] The case referenced in Exhibit 4 is an active appeal before the Tax Appeal Court, docketed as Neely v. Department of Taxation, Case No. 1CTX-20-0000106.

3. The Administrative Directive does not exceed the Department's Statutory Authority to Assess and Collect Taxes.

The Plaintiff has failed to make any factual showing that the Administrative Directive exceeded the Department's statutory powers to assess and collect taxes.

- There is no evidence in the record that the Director of Taxation issued "orders" by way of the Administrative Directive. See Plaintiff's MSJ, Mem. in Supp. at 1.
- There is no evidence in the record that the Director of Taxation caused the Administrative Directive to be disseminated to the Department of Taxation employees. See Plaintiff's MSJ, Mem. in Supp. at 2.
- There is no evidence in the record that the Administrative Directive was not disseminated to the public. See Plaintiff's MSJ, Mem. in Supp. at 2.
- There is no evidence in the record showing that the Administrative Directive was not published on the Department's website or otherwise disclosed to the public. See Plaintiff's MSJ, Mem. in Supp. at 2.

More importantly, Plaintiff fails to provide any facts demonstrating that the Administrative Directive was ever used to impose an underpayment penalty in HRS § 231-39(b)(2)(A). Instead, Plaintiff simply attaches a copy of a Notice of Final Assessment that contains an additional amount of tax assessed pursuant to HRS § 231-39(b)(2)(A), without more, as "evidence" that the application of the Administrative Directive may be impossible to identify. See Plaintiff's MSJ, Mem. in Supp. at 5; Exhibit 4. Clearly, this is not factually sufficient to carry Plaintiff's MSJ. Indeed, as noted above, this particular assessment – including the additional amount of tax assessed pursuant to HRS § 231-39(b)(2)(A) – is currently on appeal before the Tax Appeal Court as Case No. 1CTX-20-0000106, where the taxpayer has the

availability of the legal discovery process to flesh out the facts to contest the appropriateness of the penalty.[3] As such, the Plaintiff's MSJ must be denied.

Despite the Tax Appeal Court being the correct forum for this matter, in an abundance of caution, the Department will address Plaintiffs remaining arguments. Plaintiff's argument that the "failure to respond" condition in the Administrative Directive goes far beyond the statute because the penalty can be imposed for unrelated conduct is fundamentally flawed. Putting aside the argument that Plaintiff completely disregards the application of HRS § 231-39(b)(2)(A) to taxpayers who failed to file returns, its assertion that "nothing that happens during the audit can be related to whether or not there is a statutory basis for the negligence penalty" is simply incorrect. See Plaintiff's MSJ, Mem. in. Supp. at 4. Under Plaintiff's erroneous reading of the statute, the Department would be precluded from considering *any* factors after a return is filed including the Department's discovery of facts during the audit, that occurred after taxpayer's returns were filed, which demonstrate that taxpayer was in indeed negligent in not making a timely payment.

Plaintiff clearly conflates two separate occurrences: (1) the underpayment of taxes when the return is filed, and (2) the addition of taxes due to negligence or intentional disregard of rules. For the failure to pay tax, HRS § 231-39(b)(2)(A) provides for an additional amount to be added to the taxes owed by the taxpayer:

> If any part of any underpayment is due to negligence or intentional disregard of rules (but without intent to defraud), there shall be added to the tax an amount of up to twenty-five per cent of the underpayment as determined by the Director.

[3] Plaintiff's counsel is the attorney of record for Neely v. Department of Taxation, Case No. 1CTX-20-0000106.

The Administrative Directive provides guidance that negligence or disregard of rules or regulations could include a failure to respond to the auditor or examiner's request. As such, there are situations where the Department can, and *should*, consider factors that may affect the imposition of additional amounts which range from 0%-25% after the return is filed.

The case cited by the Plaintiff, Masterson v. Commissioner, T.C. Memo. 1981-681, 42 T.C.M. (CCH) 1758, does not support Plaintiff assertion, that the failure to respond cannot be used as a basis for the penalties imposed by HRS § 231-39(b)(2)(A). The Court in Masterson did not hold that additional taxes could not be imposed for negligence or disregard of rules. Indeed, it held "[w]e hasten to point out that the section 6653(a)[4] addition to tax is imposed by reason of some negligence or intentional act[s] causing a deficiency." Id. at 1761. Instead, the Court found the IRS' specific request for the penalty to be imposed for the "inordinate amount of time it spent on the Petitioner's case" improper. See id.

This is not the same situation currently before this Court. Plaintiff here makes no showing that the underpayment in HRS § 231-39(b)(2)(A) is imposed on taxpayers based on the amount of time the Department spent on a taxpayer's case. Nor has the Plaintiff provided facts that the Department imposes the underpayment in HRS § 231-39(b)(2)(A) for "dilatory tactics."[5]

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[4] Currently I.R.C. § 6662(b)(1).

[5] Indeed, the "dilatory tactics" alleged in the Masterson case were based on the taxpayer's beliefs regarding their constitutional and procedural rights. Id. n.10. And in Hawaii, "[a]n appeal to the tax appeal court shall bring up for review all questions of fact and all question of law, including constitutional questions, necessary to the determination of the objections raised by the taxpayer or county in the notice of appeal." HRS § 232-16. This supports the Department's assertion that Tax Appeal Court is the proper forum for Plainitff's Complaint. Notably, the fact that in Masterson, the U.S. Tax Appeal Court exercised jurisdiction over whether the IRS had an appropriate basis to impose a negligence penalty supports the Department's contention that this case belongs in Tax Appeal Court.

Finally, Plaintiff's concern that the taxpayer would have the burden of disproving the penalty is unwarranted. See Plaintiff's MSJ, Mem. in Supp at 5. Tax assessments in Hawaii are presumed correct. See HRS §§ 231-20 and 232-13. Therefore, *all* taxpayers, not just those subject to the penalty in HRS § 632-1, have the burden of "disproving" assessments in tax appeals. This presumption exists for challenges to the application of the penalty at the federal level well. See Masterson 42 T.C.M. (CCH) at 1761 ("respondent's imposition of the addition to tax is presumptively correct, and petitioners bear the burden of proving the assessment wrong."(citations omitted).

B. The Administrative Directive Is Not a Rule and The Department Is Not Required to Comply With Rulemaking Sections of Chapter 91.

1. The Director Has Discretion To Impose Tax Penalties.

The Legislature has expressly given the Director or Taxation broad authority with respect to the revenue laws of the State. To carry out its statutory responsibilities, the Department is authorized to "make any assessment [required to be made] by law" and "to be responsible for the collection of all taxes imposed under title 14," except for those designated to the counties. HRS §§ 231-3(1) and (2). In furtherance of this duty, the Department has the power to "examine the books and papers of account of any person for the purpose of enabling the department to obtain all information that could in any manner aid the department in discharging its duties under any tax law." HRS § 231-3(6). For failures to comply with the tax laws of the state, HRS § 231-3(4), requires that the Department "see that penalties are enforced when prescribed by any tax or revenue law of the State (the administration of which is within the scope of the department's duties) for disobedience or evading of its provisions." The penalty at issue HRS § 231-39(b)(2)(A) specifically provides:

> If any part of any underpayment is due to negligence or intentional disregard of rules (but without intent to defraud), there shall be added to the tax an amount up to twenty-five per cent of the underpayment as determined by the director. (Emphasis added).

And, while the Department has the authority "[t]o adopt such rules as the department may deem proper effectually to carry out the purposes for which the department is constituted and to regulate matters of procedure by or before the department," the requirement to adopt rules is discretionary. See HRS § 231-3(9).

As set forth above, the Director's statutorily granted authority with respect to the appropriate assessment and collection of the revenues laws of the State are markedly broad. Despite this, the Plaintiff fails to cite any statutory or case law authority requiring the Director to promulgate rules when assessing taxes or imposing penalties. An example of a statute requiring the Director to promulgate rules when imposing penalties is HRS § 231-10.6, which expressly requires rules, including temporary rules, be implemented explaining the penalties and fines for the following: "(1) the understatement of taxes; (2) promotion of abusive tax shelters, erroneous claims for refund or credit; (3) or substantial understatement or misstatements of tax." Notably, there is no similar statutory requirement to promulgate a rule or a temporary rule explaining the penalties for the underpayment of taxes. Under the Appellant's argument the Director would need to promulgate an administrative rule every time he exercises his statutory duty and power to assess penalties for the underpayment of taxes. The Department asserts this would be an unreasonable restriction on the specific statutory powers granted by the Legislature in HRS § 231-3.

2. *Plaintiff Makes No Showing Rulemaking Procedures Are Required.*

Plaintiff argues that the Administrative Directive is a rule and therefore, the Department's failure to comply with the Hawaii Administrative Procedures Act renders the Administrative

Directive invalid. In support of this argument, Plaintiff cites to Ainoa v. Unemployment Compensation Appeals Division, 62 Haw 286, 614 P. 2d 380 (1980). In Ainoa, Unemployment Compensation Appeal referees used certain statements containing the Department of Labor's interpretation of the term "available for work" to decide unemployment insurance benefit claim appeals. In Ainoa, the Court had the necessary facts needed to make an informed decision regarding whether the statements provided to the referees were rules. "The pertinent facts and circumstances for disposition of the appeal [were] undisputed," including the following:

> These statements were prepared, printed and furnished to all referees by the Department. . . . [I]t is undeniable that during appellants' hearing, the referees had access to the statements, which were kept in their notebooks, and relied on them to make their decisions; the referees' decisions in fact recited verbatim the language of the statements. Appellants were never furnished copies of these statements before their hearings.

62 Haw at 288-289, 614 P.2d at 282-383. Here, Plaintiff offers this Court no pertinent facts upon which it can dispose of this matter. Unlike in Ainoa, Plaintiff does not provide any facts proving how the Administrative Directive was prepared, where it was distributed, or how it was used. Consequently, this Court has no information upon which it is able to make a complete and fully-informed decision regarding the Administrative Directive. As Plaintiff fails to present any facts pertinent to this Court's determination of the matter, its Motion for Summary Judgment must be denied.

C. TAX FOUNDATION IS NOT AN "INTERESTED PERSON" UNDER SECTION 91-7, HRS.

"Any interested person may obtain judicial declaration as to the validity of an agency rule . . . by bringing an action against the agency in the circuit court of the county in which petitioner resides or has its principal place of business." HRS § 91-7(a). To be an "interested person" under HRS § 91-7, a person must be "affected" by or "involved" with the validity of an agency rule.

Asato v. Procurement Policy Board, 132 Hawaii 333, 343, 322 P.3d 228, 238. (2014). Without, conceding that the Administrative Directive is a rule, Plaintiff does not have standing as an "interested person" pursuant to HRS § 91-7(a).

In Asato, a taxpayer challenged a procurement regulation that waived the number of qualified applicants required for consideration for a government professional service contract where the minimum number of applicants was set by statute. Id. at 337, 322 P.3d at 232. And where Asato could show that he "qualifie[d] as an 'interested person' because, as a taxpayer challenging a specific public bidding procedure, he may be affected by the validity of a regulation that allegedly allowed an illegal expenditure of public funds," Plaintiff here makes no similar showing it is an "interested person" See Id. at 343, 322 P.3d at 238.

Indeed, Plaintiff here does not demonstrate how it "may be affected" by the Administrative Directive and instead, simply states that it is a "governmental financial accountability watchdog" as it was in the Tax Foundation case. See Plaintiff's MSJ, Mem. in Supp. at 9. However, Plaintiff's standing as a "governmental financial accountability watchdog" in the Tax Foundation case by itself does not confer standing on the Plaintiff as an interested person *in this case*. In Tax Foundation, the Court's finding of a correlation between Plaintiff's status as a government financial accountability watchdog and "the administration and allocation" of the county surcharge after collection is reasonable. However, here, Plaintiff cannot demonstrate how as a "government financial accountability watchdog" it is affected by the validity of a regulation that does not concern the expenditure of public funds, but instead relates to the Department's audit of an individual taxpayer in furtherance of its statutory authority to assess and collect taxes. Therefore, Plaintiff here cannot assert standing as an "interested person" pursuant to HRS § 91-7(a).

V. CONCLUSION

Declaratory Judgment is not appropriate in this controversy with respect to taxes. Nor is the Plaintiff an "interested person" who may obtain a judicial declaration pursuant to Chapter 91, HRS. For the foregoing reasons and authorities, the Department respectfully requests that this Honorable Court deny Plaintiff's Motion for Summary Judgment.

DATED: Honolulu, Hawaii, July 2, 2024

/s/ Janine R. Udui
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IN THE CIRCUIT COURT OF THE FIRST CIRCUIT

STATE OF HAWAII

In re DEPARTMENT OF TAXATION, ADMINSTRATIVE DIRECTIVE NO. 2021-01. TAX FOUNDATION OF HAWAI'I, a Hawai'i nonprofit corporation, Plaintiff, vs. DEPARTMENT OF TAXATION, STATE OF HAWAI'I, Defendant.	CIVIL NO. 1CCV-24-0000661 CERTIFICATE OF SERVICE

CERTIFICATE OF SERVICE

The undersigned certifies that on July 2, 2024, a copy of the foregoing was duly served on the following party/parties via the Hawaii State Judiciary Electronic Filings and Service System (JEFS) as indicated on the corresponding Notice of Electronic Filing:

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