Hawaii Department of Taxation Targets Non-Filing Non-Resident Rental Real Property Owners; Department Is Using Data-Sorting To Identify Tax 'Scofflaws'

The State of Hawaii Department of Taxation describes its efforts to bring non-resident rental real property non-filers into Hawaii's tax system at the 2012 Year-End Tax Workshop. New sources of information include Homeowner's Associations and the Counties.

The Department announced that:

- "Computer analytics" are used to identify potential non-compliant persons for audits, special enforcement, and criminal investigation;
- Income tax return processing times are delayed for Schedule C and E filers with unfiled General Excise and Transient Accommodations tax returns;
- The Department is working with the counties to identify rental and transient accommodations properties, as the counties are interested in inappropriate claims of homeowner's exemptions (for real property tax purposes); and,
- Implementation of Act 326 of 2012 (requiring AOAO/Associations to collect and report Transient Accommodations activities to the Department) has been delayed by a need by the Department to obtain the information in a manner that the Department can effectively utilize.

Background: The Department has long considered non-filing rental property owners and vacation rental operators as a potential source of additional tax revenue. This is especially true for transient accommodations (short term/vacation rentals) as the TA rate is 9.25% and the GE rate is 4% (4.5% in the City & County of Honolulu.) In addition, GE and TA are computed on a gross receipts basis and are relatively easy to determine (compared to the relatively complexity of an income tax assessment.)

What's New Here? Previously, some tax professionals believed the Department was able to identify some types of "partial" filers. Partial filers are taxpayers filing a federal 1040 with Schedule C and/or Schedule E but without a State of Hawaii Net Income, or GE or TA returns. Now, *the Department has confirmed its ability to identify partial filers with data sorting*. In an interesting remark, *the Department also stated that State of Hawaii Net Income filers without GE or TA returns cause a processing delay*. The Department did not elaborate. Presumably, those taxpayers are placed upon a list for some sort of follow-up, including potentially an audit or evaluation or for potential criminal investigation.

The Department is also interested in complete non-filers. Homeowners renting rooms, floors, or cottage units, and non-resident owners of vacation rentals can be difficult to identify solely through data sorting techniques. Unlike partial filers, who have left informational "tracks" with the Department, complete non-filers are completely "under the radar."

New legislation may generate additional third-party information for the Department to identify these non-filers. Act 326 of 2012, which requires AOAO/Associations to report transient accommodation activity to the Department, may allow the Department to identify vacation rental properties where there has been no filing activity whatsoever. According to the Department, Act 326 filing will start towards the end of the first quarter 2013 as an appropriate form is being developed. I assume by "appropriate" form, the Department means a form that it can readily analyze with data sorting methods.

Finally, the comment that the Department of Taxation and the Counties were working together to identify rental activity suggests the development of additional third-party information. The Department did not elaborate but the Counties have information on building permits and other activity that could perhaps be used to identify rental activity.

Analysis: Hawaii's Department of Taxation is following a national trend of actively developing information to identify additional sources of tax revenue. Computer data sorting techniques applied to federal and state tax data should be readily able to identify potential non-compliant taxpayers for audit and investigation.

There is no statute of limitations for unfiled general excise and transient accommodations tax returns. This makes the identification of delinquent GE and TA revenue particularly productive as an audit could look back a considerable period. Typical penalties for failure to file and failure to pay are 50% along with interest at 8%.

Persons with past or on-going rental activity in Hawaii and unfiled returns (or unreported income) should strongly consider seeking professional advice as soon as possible. The potential for criminal prosecution and/or the imposition of substantial civil penalties can be mitigated or reduced through appropriate and timely actions, potentially including a "voluntary disclosure" pursuant to TIR 2010-07.

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