UNITED STATES BANKRUPTCY COURT

DISTRICT OF HAWAII

In re	)	Case No. 03-00817
	)	Chapter 11
HAWAIIAN AIRLINES, INC.,	)	
a Hawaii corporation,	)	
	)	Re: Docket No. 2942, 3718
Debtor.	)	

FINDINGS OF FACT AND CONCLUSIONS OF LAW
ON OBJECTION TO CLAIM FOR EXCISE TAX AND PENALTY

The Internal Revenue Service ("IRS") filed a proof of claim (no. 967, amended by claim no. 981) in the total amount of $128,934,576.95. The proof of claim asserts claims for various types of taxes, including fuel excise tax and penalties assessed for the alleged underpayment of that tax.

On July 28, 2004, the chapter 11 trustee objected to the claim for the penalty on the allegedly underpaid excise tax (docket no. 2942)[1]. An evidentiary hearing on the motion took place on December 13, 2004.

On November 12, 2004, the trustee filed an objection to the fuel excise tax claim (docket no. 3718). The parties argued the objection at a hearing on January 14, 2005.

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[1]The trustee also objected to and sought estimation of other components of the IRS claim. The parties settled most of those challenges prior to the hearing and the IRS reduced its total claim to $89,365,151.67 (claim no. 995). The remaining parts of the claim are still being briefed.

Because both objections present closely related issues (the allowance of the excise tax and penalty for alleged underpayment of the same tax), it is appropriate to decide them together even though they were heard separately.

Based on the evidence presented, the court makes the following:

FINDINGS OF FACT

1. Hawaiian Airlines, Inc. ("Hawaiian"), operates an airline that provides service among the Hawaiian islands, between Hawaii and points in the continental United States, and between Hawaii and certain overseas destinations.

2. Heffernan & Associates, Inc. ("Heffernan"), was in the business of providing tax consulting services. Maurice Heffernan and his son, James Heffernan, provided most of Heffernan's services. Maurice Heffernan provided most of the technical analysis which supported Heffernan's tax advice.

3. In March 2001, Christine Deister became Hawaiian's Chief Financial Officer. Shortly thereafter, Heffernan contacted Ms. Deister to offer its services to Hawaiian. Heffernan told Ms. Deister that Heffernan provided excise tax consulting services to many airlines and that Heffernan could probably help Hawaiian reduce its federal and state excise taxes.

4. Ms. Deister was already aware of Heffernan because Heffernan had provided tax consulting services to Trans World Airlines ("TWA") where Ms.

Deister had worked for about thirty-three years. Ms. Deister contacted a colleague of hers at TWA, Marian Cardona, whom Ms. Deister regarded as an expert in the taxation of airlines, to inquire into Heffernan's qualifications. Ms. Cardona recommended Heffernan highly and told Ms. Deister that Heffernan had provided similar services for TWA and several other airlines, including Continental and United.

5. At about the same time, another employee of Hawaiian told Ms. Deister that Hawaiian had considered hiring Heffernan in 1998, but had decided not to do so because Heffernan got "mixed reviews."

6. Based on Ms. Cardona's recommendation and Heffernan's description of its experience and qualifications, Ms. Deister decided that Hawaiian should retain Heffernan. Ms. Deister did not further check Heffernan's references or follow up on the "mixed reviews" which Hawaiian had received in 1998.

7. On April 9, 2001, Hawaiian and Heffernan entered into a Consulting Agreement (exhibit 2020), pursuant to which Heffernan agreed to perform a "Tax Savings Analysis" for Hawaiian and Hawaiian agreed to pay a fee to Heffernan based on a percentage of any "Tax Savings" realized by Hawaiian, but not more than $1,000,000.00. The Consulting Agreement defines "Tax Savings" as certain "final and irrevocable" cash refunds or payments to Hawaiian.

Heffernan's fee was payable fourteen days after Hawaiian "receives a Tax Savings, as defined herein . . . ."

8. On or about April 9, 2001, Maurice and James Heffernan met with Ms. Deister and other employees of Hawaiian to obtain information which Heffernan requested for its tax savings analysis. Maurice Heffernan explained that the use of fuel over international waters between Hawaii and the continental United States is not subject to excise tax and that Hawaiian could claim a retroactive credit for excise tax it had paid on such fuel during the preceding three years.

9. On April 25, 2001, Heffernan sent a letter to Ms. Deister (exhibit 2021) outlining Heffernan's tax savings analysis for Hawaiian. Heffernan represented that it had consulted with over twenty major airlines in the last six years and had saved those airlines over $100,000,000 of taxes. Heffernan further represented that the tax savings strategies it outlined for Hawaiian "have been audited by the IRS at seven (7) different airlines and past [sic] audit each and every time without adjustment." Heffernan claimed that Hawaiian could save $11,278,561 of federal fuel excise taxes if Hawaiian took advantage of the "foreign trade" fuel tax exemption. Heffernan claimed that the excise tax does not apply to fuel "'burned' over international waters" between Hawaii and the mainland, and that "the fuel used between Hawaii and the mainland has been audited twice and

passed muster each time without adjustment." Heffernan also asserted that Hawaiian could also claim an exemption from California state sales tax for fuel used over international waters between California and Hawaii. Heffernan promised to "guide" Hawaiian in claiming the exemption and completing the necessary forms.

10. Heffernan instructed Hawaiian to claim the federal excise tax credit, including the refund of the tax paid during the preceding three years, on form 720, entitled "Quarterly Federal Excise Tax Return." Heffernan calculated the amount of the credit based on data provided by Hawaiian. An employee of Hawaiian completed form 720 in accordance with Heffernan's instructions.

11. Hawaiian's form 720 for the quarter ending March 2001 was due on May 31, 2001. On the form, Hawaiian claimed a credit of $5,500,000 for the nontaxable use of aviation fuel (exhibit 2017).

12. At some point during the summer of 2001, Hawaiian asked its outside auditors, Ernst & Young ("E&Y"), how it should record the excise tax credits. E&Y told Hawaiian how to book the credits and did not immediately raise any question about their propriety.

13. By letter dated May 22, 2001 (exhibit 2022), Heffernan billed Hawaiian $725,000 as its fee for the $5,500,000 of tax savings which Hawaiian

would realize on May 31, 2001, when it filed form 720 for the quarter ending in March 2001. Heffernan "reminded" Hawaiian that, in thirty-one years, Heffernan had "never lost an IRS audit." Hawaiian promptly paid the bill.

14. Hawaiian's Board of Directors met on May 24 and 25, 2001 (exhibit 2015). At the meeting, Ms. Deister reported that, with Heffernan's assistance, Hawaiian would be able to recover approximately $11,300,000 of previously paid federal excise taxes and $4,500,000 of California state sales taxes for fuel used over international waters.

15. On May 30, 2001, Ms. Deister wrote to the California State Board of Equalization to claim a refund of California sales tax paid to vendors in California for fuel used on flights to Hawaii. By letter dated September 24, 2001, the State Board of Equalization rejected the claim for two reasons: first, because only the vendors who paid the tax to the state could claim a refund; and second, because the exemption for flights to "foreign destinations" under California state law did not apply to flights to Hawaii.

16. Hawaiian also attempted to claim the exemption from California state sales tax by sending exemption certificates to its fuel supplier, Chevron. In June 2001, Chevron informed Hawaiian that the exemption from the California state tax did not apply to flights which terminate in Hawaii (exhibit

2014). Hawaiian informed Heffernan of Chevron's position, and Heffernan promised to follow up. Contrary to Heffernan's advice, Hawaiian was never able to claim an exemption from California state sales tax for fuel used on flights ending in Hawaii.

17. The Audit Committee of Hawaiian's Board of Directors met on July 25, 2001 (exhibit 2019). The committee discussed the excise tax issues and directed management to explore claims for reimbursement from the company's current and prior accountants, E&Y and KPMG, apparently believing that the accountants' failure to advise Hawaiian of the excise tax exemption may have constituted negligence.

18. Hawaiian's form 720 for the quarter ending June 2001 was due on August 31, 2001. On August 20, 2001, Hawaiian faxed to Heffernan (exhibit 2208) a draft of Hawaiian's form 720 for the second quarter of 2001. The form claimed a credit of $6,879,218 for nontaxable use of aviation fuel. Heffernan apparently approved the draft, and Hawaiian filed the return (exhibit 2017).

19. Heffernan sent a letter to Ms. Deister, dated August 24, 2001 (exhibit 2024), explaining briefly that its tax savings strategy was based on Revenue Ruling 69-259.

20. By letter dated August 27, 2001 (exhibit 2023), Heffernan billed Hawaiian $275,000 as the balance of its maximum fee, based on the tax savings which Hawaiian would realize on August 31, 2001. Hawaiian promptly paid the bill.

21. On October 28, 2001, Ms. Deister reported to the Audit Committee of Hawaiian's Board of Directors about the fuel tax refund claims. The minutes of the meeting state that Hawaiian's legal counsel believed that Hawaiian "has a challenging legal claim against its public accountants" arising out of the "error" in payment of excise taxes. The committee asked management to discuss the matter with E&Y and attempt to obtain "equitable restitution" for the interest lost on the overpaid taxes.

22. In late 2001, while helping Hawaiian to close its books for the year and preparing for the audit of Hawaiian's 2001 financial statements, E&Y began to raise questions about the fuel excise tax credits which Heffernan had identified. The issue was relevant to E&Y's audit work because, under applicable accounting standards, E&Y could opine favorably on Hawaiian's financial statements only if E&Y came to the conclusion that Hawaiian would "more likely than not" prevail in its claim for the fuel excise tax credits. E&Y engaged in substantial discussion and analysis of the issue, both internally among E&Y

personnel and with Hawaiian. E&Y also spoke to Heffernan and another airline which had successfully claimed the same credit based on Heffernan's advice.

23. Ms. Deister contacted Heffernan to discuss E&Y's concerns about the excise tax credits. On March 1, 2002, Heffernan wrote to Ms. Deister that Heffernan "has not found any IRS rulings that indicate that the fuel used on [flights from the continental U.S. to Alaska or Hawaii] is taxable or not taxable." Heffernan opined, however, that the fuel should be exempt from tax, based on analogies between the fuel excise tax and the excise taxes on transportation of persons and property between those destinations.

24. Eventually, in or around March 2002 (exhibit 2006), E&Y concluded that it was not "more likely that not" that Hawaiian would prevail if the IRS were to question the excise tax credit. Therefore, E&Y required Hawaiian to reverse the credit on its financial statements.

25. In May 2002, Maurice Heffernan died and the Heffernan firm ceased operations.

26. In September 2002, E&Y told Hawaiian (exhibit 2007) that Hawaiian must accrue a potential liability for interest on the credit.

27. In October 2002, E&Y considered whether Hawaiian should also accrue a potential liability for a penalty based on Hawaiian's claim of the

excise tax credit (exhibit 2011). E&Y was particularly concerned about this possibility because an E&Y partner believed that form 720 was not properly used to claim a retroactive credit and that the IRS might infer that Hawaiian was attempting to hide its claim. E&Y eventually concluded that it was sufficient to mention this possibility in a footnote to the financial statements.

28. The IRS audited Hawaiian's 2001 and 2002 tax returns, including form 720 on which Hawaiian had claimed the fuel excise tax credit. The IRS issued Notices of Proposed Adjustment (exhibits 2029 and 5007) which disallowed the claimed credit and imposed a 200% penalty pursuant to 26 U.S.C. § 6675.

29. Hawaiian commenced this chapter 11 bankruptcy proceeding on March 21, 2003. The IRS filed an amended proof of claim (no. 981) which includes $22,036,863 for the disputed excise tax credit and pre-petition interest thereon, and the 200% penalty in the amount of $40,546,599. The IRS also filed an administrative proof of claim for post-petition excise tax and interest totaling $1,199,287.

Based on the foregoing findings of fact, the court makes the following:

CONCLUSIONS OF LAW

A. Jurisdiction.

1. The court has jurisdiction of this contested matter pursuant to 28 U.S.C. §§ 1334 and 157(a). This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2)(B).

B. The Fuel Excise Tax and the Supplies Exemption.

2. Section 4091 of the Internal Revenue Code (26 U.S.C., sometimes cited herein as "IRC") imposes an excise tax on the sale of aviation fuel. Section 4221 of the IRC provides, however, that the sale of aviation fuel for certain purposes is not subject to the excise tax. One nontaxable use (the "Supplies Exemption") is where the fuel is sold "for use by the purchaser as supplies for vessels or aircraft . . . ." Section 4221(d) provides that "supplies for vessels or aircraft" includes "fuel supplies . . . on civil aircraft employed in foreign trade or trade between the United States and any of its possessions . . . ."

3. The Trustee contends that Hawaii should be treated as a "possession" for purposes of IRC section 4221 and that the Supplies Exemption therefore applies to aviation fuel used in trade between the continental United States and Hawaii. The IRS takes the opposite position, asserting that Hawaii is not a "possession."

4. The plain language of IRC section 4221 supports the IRS's position. Hawaii is one of the United States, not a possession of the United States. Trade between the state of Hawaii and the other states is not "foreign trade or trade between the United States and any of its possessions . . . ."

5. The trustee argues that the court should look beyond the plain language of the statute and consider the history and purpose of the Supplies Exemption. Assuming that it is appropriate to look beyond the plain language of the statute, I still reach the same result.

6. The trustee points out that Hawaii was a territory, not a state, when Congress enacted the Supplies Exemption in 1933 and extended it from ships to aircraft in 1938. The trustee claims that the Supplies Exemption applied to flights between Hawaii and the mainland prior to 1959 because Hawaii was a "possession" for purposes of the exemption. The IRS contends, however, that Hawaii was considered a "state" for purposes of the Supplies Exemption before it actually became a state. In support of this deviation from the "plain meaning" rule of statutory interpretation, the IRS cites section 3797 of the 1939 version of the IRC:

> (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof –
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> * * *

> (9) United States – The term "Unites States" when used in a geographical sense includes only the States, the Territories of Alaska and Hawaii, and the District of Columbia.
>
> (10) State – The word "State" shall be construed to include the Territories and the District of Columbia, where such construction is necessary to carry out provisions of this title.

Exhibit 1 to the IRS's response to the trustee's objection. The statute did not define the term "possessions." Beginning in 1944, the Treasury Regulations provided the following definition:

> The term "possession of the United States" includes the Philippine Islands, the Panama Canal Zone, the Virgin Islands, Guam, Puerto Rico, American Samoa, Wake, and the Midway Islands.

Treas. Reg. 44 § 314.1(e).

7. The trustee argues that these definitions do not apply to the Supplies Exemption. He points out that the definitions in section 3797 do not apply if they would be "manifestly incompatible with the intent" of the specific provision at issue. He argues that shippers and air carriers who served ports distant from the mainland could avoid the excise tax (and reduce the revenues of domestic suppliers) by buying fuel from foreign suppliers, and that the Supplies Exemption was intended to eliminate this incentive. He also argues that the word "includes"

in the regulation means that other areas with similar characteristics should be treated as "possessions" where appropriate.

8. Considering the statutory language, context, history, and purpose, as well as the sparse judicial and administrative interpretations of the statute, it seems most reasonable to treat Hawaii as a "possession" for purposes of the Supplies Exemption prior to statehood in 1959.

9. But that cannot end the inquiry. This case turns on Hawaii's status in 1998 and subsequent years. The question is whether the Supplies Exemption applies to trade between Hawaii and the mainland after Hawaii's admission to the union in 1959.

10. At this point in the argument, the trustee and the IRS reverse roles. The IRS argues that Hawaii was a "state" for purposes of the Supplies Exemption before Hawaii actually became a state. The trustee argues that Hawaii remained a "possession" of the United States for the same purpose even after Hawaii became a state.

11. The trustee argues that "the starting point" for determining Congress' intent is the Hawaii Omnibus Act of 1960. I disagree; the correct starting point is the Admission Act of 1959 (Pub. L. 86-3, 73 Stat. 4, March 18, 1959), the law which made Hawaii a state. Section 15 of the Admission Act says

that "the laws of the United States shall have the same force and effect within the said State as elsewhere within the United States . . . ." Statehood did change Hawaii's status from a territory to a state. The Admission Act means that, after statehood, Hawaii would be treated exactly like every other state unless Congress specifically decided otherwise.

12. The Omnibus Act of 1960, on which the trustee relies, was enacted about a year after statehood in order to amend various federal statutes to reflect Hawaii's new status. Most of the amendments consisted of deleting references to "the Territory of Hawaii" or similar words. These changes not only deleted obsolete references to a defunct entity (the territory), but also made clear that Hawaii was now a state and (for the most part) was to be treated exactly like all other states. In a few respects, however, the Hawaii Omnibus Act continued to provide different treatment for Hawaii than other states. Most notably, the Omnibus Act preserved the exemption from the "ticket tax," the excise tax on transportation of persons, for travel to and from Hawaii. Id. § 18(a).

13. The most natural and reasonable interpretation of the Admission Act and the Omnibus Act is that Congress intended to treat Hawaii as a state, rather than a possession, after statehood, and that Congress also intended any changes in the legal rules which flowed from that change in status unless Congress

specifically said otherwise. Congress made (or continued) an exception with respect to the ticket tax, but never did so with respect to the Supplies Exemption. Therefore, even if the Supplies Exemption applied to trade between Hawaii and the mainland before statehood, it no longer applied after statehood.

14. Section 49 of the Omnibus Act further provides that:

> The amendment by this Act of certain statutes by deleting therefrom specific references to Hawaii or such phrases as "Territory of Hawaii" shall not be construed to affect the applicability or inapplicability in or to Hawaii of other statutes not so amended.

Section 49 does not change the result because the Supplies Exemption never contained a "specific reference" to Hawaii or a phrase like "Territory of Hawaii." Rather, IRC section 4221 refers generically to "possessions."

15. The trustee makes a number of policy arguments for why the Supplies Exemption should continue to apply to Hawaii trips. Congress might find such arguments persuasive but they do not convince me to overlook the plain language of the statute or the most reasonable interpretation of its history.

16. The trustee's objection to the portion of the IRS's claim for fuel excise tax and interest thereon should be overruled.

C. The 200% Penalty.

17. 26 U.S.C. § 6675 provides that if a taxpayer claims a larger credit under section 6427[2] than is allowable, the taxpayer is liable for a penalty "unless it is shown that the claim for such excessive amount is due to reasonable cause . . . ." The penalty is the greater of $10 or two times the excessive amount.

18. "The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances." 26 C.F.R. § 1.6664-4(b)[3]. Reliance on the advice of a professional tax advisor can constitute "reasonable cause," if such reliance was reasonable considering all pertinent facts and circumstances. Id. § 1.6664.4(c).

19. Hawaiian relied on the advice of Heffernan, a qualified tax professional, when it claimed the excise tax credit. Hawaiian's reliance was reasonable considering all pertinent facts and circumstances. Heffernan had the expertise necessary to give the advice which it gave to Hawaiian. Hawaiian made reasonable efforts to validate Heffernan's qualifications and expertise and to

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[2] This decision is based on 26 U.S.C. § 6427 prior to the amendments of 2004. Former section 6427(l)(1) allowed a credit for tax paid on aviation fuel under § 4091.

[3] "Reasonable cause" is not defined under 26 U.S.C. § 6675. However, Treasury Regulation 26 C.F.R. § 1.6664-4 promulgated under 26 U.S.C. § 6662, the statute governing accuracy-related penalties, provides further guidance as to the meaning of "reasonable cause."

confirm that at least one other airline had successfully taken the excise tax credit which Heffernan suggested to Hawaiian. Hawaiian provided all information which Heffernan needed to form its conclusions. There are good faith arguments supporting Heffernan's conclusion that fuel consumed on flights between Hawaii and the continental United States is not subject to excise tax. The facts that Heffernan's fee was dependent upon its ability to secure tax savings for Hawaiian, that E&Y disagreed with Heffernan's advice, and that E&Y was right and Heffernan was wrong, do not outweigh all of the other facts and circumstances indicating that Hawaiian's reliance on Heffernan was reasonable.

20. The trustee's objection to the IRS's claim for a penalty on the unpaid fuel excise tax should be sustained and such claim should be disallowed in its entirety.

21. At the hearing set for February 15, 2005, on the remaining claims objected to by the trustee, the parties should be prepared to discuss the form of judgment to be entered in conformity with this decision.

UNITED STATES BANKRUPTCY COURT
DISTRICT OF HAWAII

/s/ Robert J. Faris
United States Bankruptcy Judge
Dated: February 01, 2005