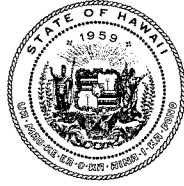


REPORT OF THE
2005 – 2007 TAX REVIEW COMMISSION

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Governor

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Lieutenant Governor



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December 1, 2006

To the Honorable Members of the Twenty-Fourth Legislature:

The Tax Review Commission is pleased to submit this report, which contains its review of Hawaii's tax structure and recommendations for change. The review and recommendations are submitted in accordance with Act 218, Session Laws of Hawaii (SLH) 1979, as amended by Act 212, SLH 1983.

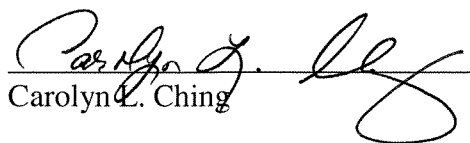
Each Commission member supports this report. This does not mean that every Commissioner approved of every recommendation. Some recommendations represent compromises among us and others were made on the basis of a majority vote. Rather, it means that each of us approves of the report as a whole, and we take pride in the overall result of our efforts. We sincerely hope you find our recommendations helpful when you formulate your tax policies in future.

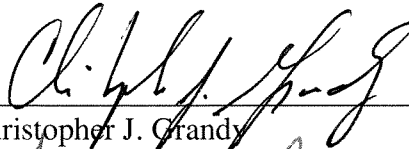
Respectfully Submitted,


TAX REVIEW COMMISSION



Isaac W. Choy, Chair

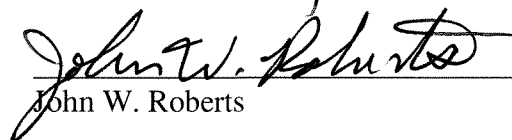

Ronald I. Heller, Vice-Chair


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ACKNOWLEDGEMENTS

This is the report of the 2005-2007 Tax Review Commission. The Commission is composed of seven unpaid members who have spent their valuable time to help the State evaluate the structure of its taxes.

The Commission wishes to acknowledge the Department of Taxation for technical and administrative assistance. We would like particularly to thank Kurt Kawafuchi, the Director of Taxation, for his active involvement in providing his Department's resources to help the Commission with its work. We would also like to acknowledge the dedicated performance of the Tax Research and Planning Office, which provided technical and administrative support for the Commission. Despite staff shortages and a high rate of turnover during the Commission's tenure, the Tax Research and Planning Office was able to effectively organize and coordinate the Commission's meetings, prepare minutes for its meetings, keep records of its correspondence, arrange travel for its members, solicit proposals for external studies, draft much of the Commission's report, and conduct many of the studies requested by the Commission. We also thank Nelson B. Befitel, Director of the Department of Labor and Industrial Relations, and Georgina K. Kawamura, Director of Budget and Finance, for providing reports and information to the Commission.

The Commission has also been greatly aided in its task by comments and suggestions from people in the tax community and from the public at large. We wish to thank those who have attended its meetings or who offered suggestions or comments. We extend special thanks to Jeff Au, Managing Director, PacificCap Group; Huong Bassford, Senior Resource Allocation System Analyst, Department of Budget and Finance; Ann H. Chung, Vice President, Hawaii Science & Technology Council, Diane Erickson, Deputy Attorney General, Department of the Attorney General; Craig Hirai, Chair of the Tax Review Commission of 2001-2003; Lowell Kalapa, President of the Tax Foundation of Hawaii; Ray Kamikawa, Partner, Chun, Kerr, Dodd, Beaman & Wong; Marilyn Niwao, Principal, Niwao & Roberts, CPA's; Ronald Randall, Taxation Compliance Administrator of the Department of Taxation; Robert Robinson, Convener, UH Angels; Thomas Smyth, Program Manager, Department of Business, Economic Development and Tourism; Bill Spencer, President, Hawaii Venture Capital Association; Pat Sullivan, President and Chief Executive Officer, Oceanit/Hoana Medical; David Watumull, President and Chief Executive Officer, Cardax Pharmaceuticals; and others who have generously availed us of their time and expertise. We also thank Sean Hao of the Honolulu Advertiser and Stewart Yerton of the Honolulu Star Bulletin for helping disseminate important parts of the Commission's work to the public. However, the members of the Commission retain sole responsibility for the recommendations contained in this report.

THE 2005-2007 TAX REVIEW COMMISSION

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REPORT OF THE 2005-2007 TAX REVIEW COMMISSION

I. THE TAX REVIEW COMMISSION'S MANDATE

Section 232E-3 of the Hawaii Revised Statutes, adopted pursuant to the 1978 amendment to the Hawaii State Constitution, directs the Tax Review Commission to "conduct a systematic review of the State's tax structure, using such standards as equity and efficiency." To be systematic, the review should be complete, thorough and well ordered, but the Commission did not have the time or resources to look at every tax the State imposes. Instead, we looked at suggestions and concerns received from the public and at selected topics we felt needed to be reviewed.

It is difficult to design tax policy to meet goals of equity and efficiency, because these goals often conflict. Nevertheless, past Tax Review Commissions were able to come up with many good recommendations. Unfortunately, much of their advice has not been implemented, because elected officials generally weigh the dictates of sound tax policy against other political objectives, including those of organized groups with well-defined goals and strong opinions. This report gives policy officials our views on what constitutes sound tax policy. We hope it will provide a background theme that can be played as political decisions on taxes are made.

II. PRINCIPLES OF SOUND TAX POLICY

A. FAIRNESS

"The expenses of government, having for their object the interest of all, should be borne by everyone, and the more a man enjoys the advantages of society, the more he ought to hold himself honored in contributing to those expenses."

– Anne Robert Jacques Turgot

Standards of tax fairness are hard to set, because what makes taxes fair depends on one's perspective. Two classic criteria used to judge tax fairness are horizontal equity and vertical equity. Horizontal equity means that people in similar economic circumstances are taxed equally. Vertical equity usually is taken to mean that people with higher incomes should face a higher tax rate, that is, that the tax burden should be distributed according to the taxpayer's "ability to pay." Another way this idea is sometimes expressed is that "taxes should impose the same pain on everyone, so the wealthy should pay more than the poor." To satisfy the principle of vertical equity, most income tax codes feature graduated tax rates, with exemptions and deductions to further help the lower income taxpayer. However, the questions of who has the ability to pay, or who is wealthy and who is poor, can be argued forever.

An alternative to the "ability to pay" principle is the "benefits principle," which says that those who benefit from government programs or services should pay for them. The benefits principle cannot always be applied, however, because basic government services often go to people who cannot afford them.

The Commission's mandate is to examine the fairness of the entire tax structure, not of each individual tax. Consequently, it is not necessary for each tax to meet a standard of vertical equity on its own, because one tax can be used to compensate for another tax's shortcomings. For instance, a refundable income tax credit can be used to make the General Excise Tax (GET) less

regressive.¹ To examine the vertical equity of the tax system as a whole, we looked at the distribution of tax burdens at different income levels. Overall, we believe that Hawaii's tax system represents a good compromise between the requirements of efficiency and fairness.

B. EFFICIENCY

"Any tax is a discouragement and therefore a regulation as far as it goes."

– *Oliver Wendell Holmes, Jr.*

Most taxes impose a cost on taxpayers over and above the amount of the tax collected.² The extra cost is called the excess burden of the tax.³ The excess burden includes the costs of administering and collecting the tax, and the costs taxpayers incur to comply with the tax and to pay it. The biggest part of the excess burden, however, comes from the effects the tax has on people's economic decisions, such as what to buy, how much to work, or where to invest. When taxes influence economic decisions, they tend to cause people to allocate resources inefficiently. For example, the federal Tax Reform Act of 1986 is credited with eliminating a lot of waste that happened because the prior tax code encouraged people to invest in tax shelters instead of viable productive enterprises.⁴

There are two good rules to minimize economic inefficiencies caused by taxes. First, the tax base should be made as broad as possible so the tax rate can be kept low. Second, the tax

¹ As broad as it is, the mandate may nevertheless be too narrow. If the efficient way for the rich to help the poor is to combine a regressive tax structure with progressive government spending, the solution should not be put out of reach by arbitrarily requiring that the tax system be non-regressive. Noted economist Milton Friedman once suggested replacing the graduated federal income tax rates and the entire welfare bureaucracy with a flat-rate income tax and automatic payments to people with low incomes.

² Some taxes actually provide a benefit, but such taxes typically have relatively low revenue potential. Examples are taxes that reduce negative externalities, such as gasoline taxes that reduce pollution and congestion by discouraging people from driving, or liquor and tobacco taxes that promote health by discouraging people from consuming these commodities. Taxes on liquor, tobacco and fuel account for about 7 percent of all State tax collections in Hawaii.

³ The excess burden is sometimes called the deadweight loss of the tax.

⁴ See C. Eugene Steuerle, *Contemporary U.S. Tax Policy*, Urban Institute Press, 2004, pp. 133-136.

should be applied uniformly to its base to avoid favoring one type of consumption or investment over another.⁵ The second rule is sometimes referred to as the principle of tax neutrality.

Tax rates should be kept low, because the inefficiencies caused by taxes tend to grow geometrically, rather than proportionally, as the tax rate rises. Doubling the tax rate typically more than doubles the excess burden. Keeping taxes uniform also promotes efficiency. A non-uniform tax distorts economic decisions, encouraging people to consume more of the lightly taxed items. It also increases the costs of tax compliance and tax administration, because it forces tax authorities and taxpayers to distinguish between taxed and untaxed items.

C. SIMPLICITY

"Tax complexity itself is a kind of tax."

– *Max Baucus*

Simplicity is a desirable trait for taxes. The main benefit from keeping taxes simple is that it reduces costs of tax compliance for taxpayers and of tax administration for the government. Special deductions, exemptions and exclusions complicate a tax and make it less efficient by increasing the costs of tax compliance and tax administration, and by distorting more economic choices. Simple taxes are also easier for taxpayers to understand and comply with, and therefore give them greater confidence in the system.

⁵ The second principle suggests that tax preferences should be avoided, because they result in uneven tax rates.

D. TRANSPARENCY AND ACCOUNTABILITY

"The purse of the people is the real seat of sensibility. Let it be drawn upon largely, and they will then listen to truths which could not excite them through any other organ."

– Thomas Jefferson

Taxpayers should be able to see clearly the taxes they are paying, so they can make informed decisions, as voters on how they wish to be taxed and how much they want to spend on government. Transparency also helps keep the tax system functioning smoothly. Voters should know who is responsible for the tax laws, so they know whom to hold accountable. Voters should be given as much information as reasonably possible on who gets preferential tax treatment from the government, and why. The government should make deliberations on tax policy available to the public, so voters can determine whether elected officials are working in the public interest. It should also be clear to taxpayers that noncompliance will be punished; otherwise widespread tax evasion will greatly increase the cost of administering taxes. When taxes are poorly administered or enforced, it increases the chances that they will be applied unevenly and that they will be perceived as unfair.

E. ADEQUACY AND STABILITY

Taxes should raise the appropriate amount of revenue needed for the government services demanded by its citizens, neither more nor less. A tax structure is stable if it automatically provides the right amount of revenue as the economy grows. A tax structure that habitually produces revenue shortfalls or surpluses is inefficient, because it requires frequent changes to the tax law to adjust revenues. This imposes administrative costs on the government, and it also imposes adjustment costs on taxpayers by causing them to change their habits. The Commission

has addressed the questions of adequacy and stability by examining the rate at which tax revenues grow automatically as personal income in Hawaii grows.⁶

F. COMPETITIVENESS

"There may be liberty and justice for all, but there are tax breaks only for some."

– Martin A. Sullivan

Competitiveness is too often used as a reason to justify encouraging one industry at the expense of others.⁷ When considering whether to promote a particular industry, policy makers should first ask themselves why it wouldn't flourish in the natural economic environment, facing the same taxes as other businesses.

A common argument for business tax incentives is that they are needed to attract or keep certain businesses. In theory, some activities are worth subsidizing, but in practice, government attempts to find favorable businesses have caused "picking the winners" to become a term of scorn. Generally, it is not a good idea to raise taxes for everyone in order to provide special treatment for favored industries, regardless of what other states are doing.⁸ If government wants to participate in business incentives, it should be able to verify that the chosen ventures provide worthwhile benefits to the people of the state.

⁶ Tax Research and Planning Office, "Study on the Question 'Is Hawaii's Tax Structure Adequate?'" report prepared for the 2005-2007 Tax Review Commission, November 2006. (See Appendix A.)

⁷ Policies to promote competitiveness have been labeled variously as "industrial policy" and "picking the winners."

⁸ Sometimes, industry representatives will approach a jurisdiction to ask for special tax favors, arguing that "we will not come without the tax break, so it will cost you nothing." This line of reasoning fails to recognize that the new industry will compete for resources with other local businesses that don't have the tax advantage. In a variant of the argument, an existing activity may argue that a tax break would allow it to expand, producing more than enough revenue to repay the tax break. This is another misleading argument. The growth of tax-favored activities more often comes at the expense of other activities.

III. RECOMMENDATIONS AND ANALYSIS

The Commission has used the above-listed principles of sound tax policy as a guide in developing its recommendations. To aid in our deliberations, we solicited suggestions from the public and reviewed the recommendations made by all of the past Tax Review Commissions. We also commissioned in-depth studies to evaluate the efficiency and equity of the State's tax structure. The studies examined the following topics: The adequacy of the tax structure; the progressive or regressive nature of the tax structure; the structure of the GET; the revenue costs of various exemptions and deductions from the GET; the costs and benefits of the income tax credit for high-technology investments; **the revenue costs** of expanding the Individual Income Tax brackets, of **providing a State earned income tax credit, and of providing income tax credits for food, medical services and non-prescription drugs**; and the effects of eliminating Hawaii's net income and franchise taxes and replacing the revenue with increases in the GET and the Public Service Company Tax (PSCT).

The studies are appended to this report. Based on the results, we believe Hawaii's tax system is basically sound. It provides a relatively stable stream of revenue that tends to grow automatically at a rate slightly greater than the growth of personal income. Overall, the actions of the Legislature have tended to curb the growth in tax revenues, mostly through changes in the provisions of the Individual Income Tax, bringing revenues into closer alignment with the growth in personal income.

Following are our recommendations and a brief explanation for each of them. We begin with recommendations on two topics that we believe are especially important at this time; namely whether Hawaii should join the Streamlined Sales Tax Project, and whether the high technology business investment tax credit is worth what it costs the State. The remaining

recommendations are divided into the following topics: recommendations that affect tax policy in general, recommendations on the General Excise and Use Taxes, recommendations on Hawaii's net income taxes, and recommendations on the administration of the State's taxes.

A. RECOMMENDATIONS ON THE STREAMLINED SALES TAX PROJECT

Background

The purpose of the Streamlined Sales Tax Project is to prevent states from losing sales or excise tax revenue on imports bought over the Internet from out-of-state sellers.⁹ Such imports are causing a growing, economically inefficient, bifurcation of economic activity between sales transactions subject to tax and those transactions that escape taxation solely because of political geography. The tax is often lost on such sales, because the sellers are not obliged to collect tax on behalf of the importing state. Currently, participation in the Project by sellers is voluntary and two of the largest Internet sellers, Amazon.com and eBay, have not joined. The success of the Project depends importantly on whether the U.S. Congress decides to pass legislation that would make the tax collection by out-of-state sellers mandatory. Those espousing the Project hope that by bringing greater uniformity to state sales taxes, Congress will be encouraged to force sellers to collect tax on sales made from one state to another. Such uniformity would also simplify matters and reduce costs for taxpayers that must comply with sales or excise taxes in a number of jurisdictions. At present, however, the five states with the largest economies (California, Texas, New York, Florida, and Illinois) have not joined.

To aid in its deliberations on this subject, the Commission held a special public hearing in which all interested parties were invited to share their views, including people in the Department of Taxation who would be responsible for administering the tax.

⁹ The same issues also apply to mail order sales, but the rapid growth of Internet-based commerce is increasing the importance of these issues.

Recommendation

The Commission believes that the goal of coordinating the collection of taxes on interstate sales, such as via the Internet, is desirable. We support the work of the Hawaii Commission on the Streamlined Sales Tax Project and believe Hawaii should remain involved in discussions on the Project. However, we do not think that Hawaii should make a formal commitment yet.

Discussion

The Commission believes that the costs of joining the Project at this time would exceed the revenue that it will provide, although it recognizes that there is a great deal of uncertainty regarding the amount of the costs and benefits. Dr. Fox, a noted expert on the topic, has estimated that the Project would provide only about \$10 million annually in revenue for the State.¹⁰ Kurt Kawafuchi, the Director of Taxation, stated before the Commission that he does not think the added revenue would merit the costs Hawaii would incur in conforming to the project. The Department of Taxation has estimated that the start-up costs of implementing an agreement would be about \$15 million and that the ongoing annual cost of administering it would be about \$4 million. The Commission notes that the largest states (by economic size) have failed to sign on to the project, jeopardizing its chances of becoming an effective vehicle for collecting the Use Tax. Until the Project shows greater promise of producing results, it is premature for Hawaii to incur the expense to join it.

B. RECOMMENDATIONS ON THE HIGH-TECHNOLOGY BUSINESS INVESTMENT TAX CREDIT

Background

Hawaii has a generous tax credit for investment in qualified high technology businesses, which are defined to include certain activities in the performing arts. The credit allows the

¹⁰ William Fox, "Implications of the Streamlined Sales Tax Agreement for the General Excise Tax Revenues," report prepared for the State of Hawaii Office of the Auditor, April 6, 2006.

investor to recoup the full amount invested (up to \$2,000,000 per investment), but it is spread over a period of at least five years. The present form of the credit was enacted in 2001 (Act 221), with alterations in 2004 (Act 215). The credit is provided by section 235-110.9 of the Hawaii Revised Statutes. It may be claimed against Hawaii's net income and franchise taxes and against the tax on insurance premiums. The purpose of the credit is to stimulate investment in Hawaii technology companies and to speed development of a local technology industry. The credit is set to expire on December 31, 2010.

The Commission contracted for a study on the costs and benefits of the credit,¹¹ but the results were not definitive, mainly because the authors were unable to get current data on either the cost of the credit or on the operations of the qualified high technology businesses. In particular, the data on the amount of the credit claimed and on the employment of the qualified high technology businesses were not available after tax year 2003. Furthermore, the data on operations of the qualified high technology businesses appear to be incomplete for 2003, possibly because companies were confused about filing requirements when the certification requirements for the credit were changed. The information on the operations of the qualified high technology companies comes from Hawaii State tax Form 317. The form is mandatory, but failure to file does not automatically negate the credit. As a result of the data shortcomings, only tentative conclusions could be reached on the cost or the benefits of the credit.

¹¹ Marcia Sakai and Bruce Bird, "Measuring the Costs and Benefits of Hawaii's Qualified High Technology Business (QHTB) Investment Tax Credit under Act 221 and Act 215," report prepared for the 2005-2007 Tax Review Commission, November 2006. (*See Appendix B.*)

Recommendation:¹²

This Commission shares the view of the 2001-2003 Tax Review Commission,

"A tax incentive program is a potential 'black hole,' because it is a future benefit of unknown proportions, which is determined by the favored taxpayer's interpretation of what the tax credit should be, and is claimed on a tax return which is confidential."

We believe Act 221/215 raises similar concerns. We recommend that the Legislature avoid using tax credits as an economic development tool. As for the high technology business investment tax credit, the cost of the credit has proven hard to determine in a timely manner. In order to get more control over the program and to curb potential abuses, the Legislature should change it from a tax credit to a program of grants administered by a State Agency. If the credit is kept, this Commission recommends the following changes be adopted, at a minimum:

- Increase transparency and timely disclosure so that the credit can be evaluated effectively. Towards this end, we believe the data reporting should be mandatory and expanded to include sales; employment by compensation ranges and status, including full-time, part-time, and seasonal; and number of trademarks, patents, and copyrights obtained during the year.*
- The data should be collected by NAICS codes and distributed to the public periodically, but not less frequently than annually.*
- To gather the data, a tax confidentiality waiver should be required so that pertinent data can be released to the public.*
- The Commission was unable to determine to its satisfaction whether the high technology business investment tax credit has achieved its goals, but we are concerned that the credit imposes a substantial drain on the resources of the State. Consequently, we believe an independent evaluation should be performed prior to any extension of the credit.*

These considerations may well apply to other tax credits. If the requirement for qualified high technology companies to report more data is implemented, the Department of Taxation should review the question of whether there is a continued need for certification.

¹² One Commissioner notes the undermining effect that could result if there is uncertainty about the credit's future. Stability is important so that investors and companies can plan ahead with confidence. Unfortunately, we do not know the extent of the costs or much about the effectiveness of the credit, because the available data are insufficient to evaluate it. The appropriate data should be assembled and a complete and fair analysis should be done before any action is taken.

Discussion

The authors of the study prepared for the Commission on the high technology business investment tax credit estimated that the credit could cost \$600 million over its lifetime,¹³ although the Commission recognizes that the estimate is subject to changes in economic conditions. The estimates of the effects on employment in the favored sectors and in the economy as a whole are also uncertain. From the data that are available, it appears that the program is expensive, but it has not produced demonstrable growth in Hawaii's technology sector.

Representatives of the technology industry have argued that if the credit is opened to legislative change, this produces uncertainty among investors, chilling their enthusiasm and contravening the purpose of the credit. The Commission has a certain amount of sympathy for this argument, but it nevertheless finds that changes are needed to allow a good evaluation of the program. In particular, more timely and complete data are needed on the operations of the qualified high technology businesses. Such data would aid in evaluating the success of the program and in identifying possible abuses. The Commission also believes that an effective way to reduce abuses of the program is to convert it from a tax credit to a program of grants made by a State agency.

C. RECOMMENDATIONS ON OVERALL TAX POLICY

Background

Two fundamental principles of good tax policy are to keep the tax base as broad as possible and to apply the tax uniformly to its base. Special exemptions or deductions violate both

¹³ See Sean Hao, "Isles' Tech Jobs Drop Despite Tax Credit," *Honolulu Advertiser*, October 7, 2006.

of these principles. The Commission urges the Legislature to weigh the costs and benefits carefully when providing special exceptions to a tax.

Recommendation 1

Minimize all tax exemptions and credits

Discussion

The present Commission notes that every other Tax Review Commission has made this recommendation, but despite this, special exemptions and credits have proliferated. Exemptions and credits shrink the tax base and result in higher tax rates on the remaining tax base. This makes the tax less efficient from an economic standpoint, and frequently makes it less equitable as well.

Recommendation 2

When enacting credits and exemptions, the Legislature should include a sunset date that will trigger a review of whether the credit or exemption should be continued.



Discussion

The State should review tax credits and exemptions to ensure that it is getting its money's worth from them. When the Legislature enacts a new credit or exemption, it should make sure that the tax break will not escape a review.

Recommendation 3

The State's tax rates should be reduced by broadening the tax bases and the overall level of the State's taxes should be lowered by exercising fiscal and political discipline.

Discussion

The Commission notes that Hawaii is one of the highest taxed states in the nation (it was ranked the fifth most highly taxed State in the nation in 2005 and 2006 by the Tax Foundation)¹⁴ and that such high taxes tend to discourage businesses from operating in the State.¹⁵

D. RECOMMENDATIONS ON THE GENERAL EXCISE AND USE TAXES

Background

The GET is Hawaii's single most important tax, providing almost half of the State's total tax revenues. An important question that is often asked is "Is the GET better than a retail sales tax?" A retail sales tax is levied on final consumption, that is, on goods and services sold to consumers for their consumption. Sales of goods or service by one business to another (so-called business-to-business sales) are exempt from the tax. Hawaii's GET is levied on the gross receipts of the business, including receipts from sales to other businesses. However, many business-to-business sales are taxed at only ½ percent, instead of the statutory rate of 4 percent that applies to retail sales. Business-to-business sales eligible for the lower tax rate include goods sold at wholesale, goods used as production inputs by a manufacturer, and goods or services that are sold to a business for resale to its customers and that are not part of the business's overhead.

A typical retail sales tax would require a substantially higher statutory tax rate to supply the same revenue as the GET, for two reasons. First, the retail sales tax is applied only once, whereas the GET is applied at multiple stages in the production process, pyramiding on itself.

¹⁴ See their website at <http://www.taxfoundation.org/taxdata/show/449.html>.

¹⁵ See the report by William Fox, "Hawaii's General Excise Tax: Should the Base Be changed?" report prepared for the 2005-2007 Tax Review Commission, October 2006. (*See Appendix C.*)

Second, the experiences of other states suggest that there are strong pressures to exempt such items as food, drugs and medical care from a sales tax.¹⁶

The GET pyramids on itself, because businesses are taxed on their sales to other businesses.¹⁷ The amount of pyramiding differs among products and services, so the effective rate of the GET is not uniform, even when the statutory tax rate is applied uniformly.¹⁸ This is inefficient and is the main disadvantage of the GET compared to the retail sales tax. However, other states' sales taxes typically also tax some business-to-business transactions. Furthermore, if adopting a sales tax caused the tax base to shrink to levels typical of other states, the resultant sales tax would be much less efficient than Hawaii's GET.

At a "big picture" level, the Commission is satisfied with the current structure and administration of the GET and we have no major changes to recommend. We believe that the GET is a relatively efficient tax and this efficiency can be maintained as long as exemptions are kept to a minimum. **In fact, we believe it is a strong contender for the title as the most efficient substantial tax levied by any state.** The GET's chief advantage is that it is applied to a large base, so it can generate a large amount of revenue at a low tax rate. Hawaii's GET has the broadest base of any state sales tax and is tied with several other state sales taxes for the lowest tax rate.¹⁹

When measured against current income, the GET is somewhat more regressive than its main competitor as a major source of revenue, the Individual Income Tax. However, there is a

¹⁶ Political platforms in Hawaii suggest that these pressures are present, even with a GET that is imposed at a fairly low rate.

¹⁷ For a good discussion of the effect of the effects of the taxes on business-to-business transactions and a summary of empirical evidence on this question, see *Ibid*, page 8. Excise taxes on capital goods would also need to be covered by the price of final goods, but Hawaii wisely offsets the excise tax on capital goods with a refundable income tax credit.

¹⁸ The GET also discriminates against local businesses that face out-of-state competition, because the Use Tax does not compensate for pyramiding of the GET.

¹⁹ *Ibid*.

tendency to overstate the regressive nature of the GET. The main source of the regressive tendency of the GET is that wealthier households typically save more of their income. However, when it is recognized that current savings usually correspond to past or future spending (i.e., when the overall lifetime impact is considered), the GET becomes much less regressive. Furthermore, the GET has the advantage that a substantially greater part of the burden of the tax can be exported to nonresidents. The study we commissioned estimated that about 38 percent of the GET is borne by nonresidents, whereas only about 23 percent of the Individual Income Tax is shifted to nonresidents.²⁰

Recommendation 1

Because the GET is a tax on consumption rather than profits, the Commission urges that consideration be given to eliminating the GET exemption for not-for-profit organizations to ensure that they are treated in the same manner as for-profit entities. (This would not affect the tax exemptions for donations or gifts to nonprofit entities; the issue is the sale of goods or services by nonprofit entities.) In the absence of eliminating this exemption, the Commission recommends that the Legislature consider establishing maximum exemption amounts for not-for-profit organizations.



Discussion

Many nonprofit entities engage in the sale of goods or services, or in other activities that are subject to the GET when performed by for-profit entities. The exemption amounts to a subsidy for the not-for-profit entities that distorts the allocation of resources, unduly encouraging consumption of their output, especially when they compete directly with for-profit entities. Furthermore, the amount of the subsidy depends on decisions made by the nonprofit entities on how much of their goods or services to provide, not on decisions made by the State. The study prepared for the Commission estimated that the GET exemption for nonprofit organizations cost

²⁰ Tax Research and Planning Office, Hawaii State Department of Taxation, "Study on the Progressive or regressive Nature of Hawaii's Taxes," report prepared for the 2005-2007 Tax Review Commission, November 2006. (See Appendix D.)

\$168.7 million in lost revenue in tax year 2006, or about 7.5 percent of total GET collections.²¹ Eliminating the exemption would allow a reduction in the statutory rate of the GET from 4 percent to about 3.7 percent. The proposal would not affect the tax exemptions for charitable donations, gifts or bequests. These items would continue to be exempt from the GET.

Recommendation 2

Proposals to exempt transactions from the GET should be weighed carefully. In general, exemption of transactions primarily affecting consumers is undesirable. The Commission therefore cautions against approving proposals to exempt health care services, food, apparel, or shelter, for example. The Commission suggests that if the Legislature finds it desirable to grant such tax relief on equity grounds, that it should pursue those goals either through low-income credits against income taxes or through the appropriation and expenditure process, which enhances transparency and accountability.

Discussion

It is estimated that exempting food, health care, clothes and shelter from the GET would have cost about \$501 million in tax year 2006, or about 22.3 percent of total GET receipts. To keep revenue constant with the exemptions, the statutory rate of the GET would need to be raised from the current level of 4 percent to about 5.1 percent.²² If such exemptions were to be undertaken to reduce the regressive nature of the GET, it would cause the tax to become more inefficient and it would increase the cost of administering the tax.

Recommendation 3

All nonprofits should be required to obtain a GET license.

²¹ William Fox, "Hawaii's General Excise Tax: Should the Base be Changed?" *Op. cit.*, page 16. The GET exemption for nonprofit organizations is contained in subsections 237-23(a)(3) to (10) of the Hawaii Revised Statutes. Subsection 237-23(b) describes the types of income the nonprofit organizations may exempt.

²² These calculations are based on estimates in *Ibid*, page 16.

Discussion

Currently, nonprofits are required to file an application for exemption from the GET. The fee for the exemption application (\$20) is the same as the fee for a GET license. However, if the nonprofits have a GET license, they would be more inclined to comply with the tax if they occasionally have taxable gross receipts.

Recommendation 4

The GET law should be rewritten to achieve clarity and transparency.

Discussion

The GET law has been enacted in bits and pieces over many years and there has never been a comprehensive review of the statutes. Organizing and rewriting the statutes would reduce compliance costs for taxpayers and the costs of tax administration for the Department of Taxation by making tax obligations clearer.

Recommendation 5

The three-year statute of limitations on assessment of the GET should start from the filing of the last of the periodic GET returns (Form G-45).



Discussion

Currently, the statute of limitations on a GET return runs from the due date of the annual return (Form G-49) or the date the return is actually filed, whichever is later. In some cases, however, taxpayers file the periodic GET returns (Form G-45, which is due monthly, quarterly or semi-annually, depending on the taxpayer's GET liability), but they are unaware that they are also required to file an annual return. The Commission also notes that the Department of Taxation does not automatically notify taxpayers when they fail to file the annual return. The Commission believes it is unfair to penalize taxpayers who file all of their periodic returns,

merely because they missed the annual return. Generally, the annual return merely repeats information already available on the periodic returns, although it sometimes acts as an amended return for the previously filed periodic returns.

E. RECOMMENDATIONS ON HAWAII'S NET INCOME TAXES

Background

Hawaii's Individual Income Tax and Corporation Income Tax follow closely the federal definitions of taxable income. The Individual Income Tax is the second most important tax for the State, producing just over a third of tax revenue in the State's General Fund. The Corporation income tax is much less important, providing only about 2 percent of the tax revenues in the General Fund. Generally speaking, with the exception of withholding taxes on sales of real property by nonresidents, the Commission recommends closer adherence to the federal individual income tax. This would ease the burden of administering the tax and also make it more progressive. The Administration and the Legislature recently made some changes to move the tax closer to the federal model (by increasing the standard deduction and widening the tax brackets), but more needs to be done.

In addition to its recommendations, the Commission also investigated the effects of eliminating the net income taxes entirely, and of replacing the revenue with increases in the State's taxes on gross income.

Recommendation 1

The State should continue to study and evaluate the option of eliminating the Hawaii Individual Income Tax. It should eliminate the Hawaii Corporation Income Tax.

Discussion

The Commission received a suggestion that all Hawaii income taxes (corporate and personal) be eliminated, with the revenue to be replaced by increases in the GET and the portion of the PSCT that is deposited into the General fund. The Commission is not ready to make that recommendation at this time, but believes that the idea deserves further consideration. The Commission requested an internal study on the topic,²³ which concluded that the statutory rate of the GET and PSCT would need to rise from its current rate of 4 percent to a value ranging from 6.7 percent to 6.9 percent, depending on whether the bank franchise taxes and the Tax on Insurance Premiums were eliminated along with the corporate and individual net income taxes. The tax regime change would reduce compliance costs for taxpayers and the costs of tax administration for the Department of Taxation.²⁴ It would also yield a more stable stream of revenue for the State and shift a greater portion of the total burden of Hawaii's taxes from residents to nonresidents. While not formally recommending this change, the Commission believes that the idea merits further study and consideration.

The Commission recommends eliminating the Corporation Income Tax, on grounds that the tax is too complex. The static effects on the State's tax revenues would be fairly small. From 1972 to 2005, the Corporation Income Tax has provided on average only about 2.3 percent of total revenues paid into the General Fund. Moreover, collections were strongly cyclical, being large when the State's economy was strong and tax revenues were high, and being small when the State's economy was weak and tax revenues were low.

²³ Tax Research and Planning Office, Hawaii State Department of Taxation, "Study on the Question 'Should Hawaii Replace Its Income and Franchise Taxes With an Increase in the General Excise Tax,'" report to the 2005-2007 Tax Review Commission, November 2006. (*See Appendix E.*)

²⁴ Businesses and individuals file more than 760,000 tax returns annually and the net income and franchise taxes account for roughly 60 percent of the 230 forms and instructions now issued by the Department of Taxation. See *Ibid*, page 18.

The academic literature on the topic indicates that small open economies, such as individual states, shoot themselves in the foot when they tax corporate income, because in the long run the burden of the tax is borne by local landowners and workers, not, as popularly believed, by the corporate shareholders.²⁵ Such jurisdictions can improve the competitiveness of their economies and the welfare of their residents by exchanging corporate income taxes for taxes on wages and land.²⁶ Popular notions of equity may explain why many small jurisdictions continue to apply corporate income taxes.

Recommendation 2

For Hawaii's Individual Income Tax, the standard deduction, the personal exemption and the tax brackets should be indexed for inflation.

Discussion

The Commission reiterates the recommendations of previous Tax Review Commissions that the Individual Income Tax should be indexed for inflation. In the past, inflation has arbitrarily reduced the value of the standard deduction and the personal exemption, and has caused tax rates to increase by forcing taxpayers into higher tax brackets. The Commission believes that changes in the income tax should be the result of deliberate policy actions, not an arbitrary result determined by inflation. With indexing, the average income tax rates will not be affected by inflation, but income tax revenues will tend to grow automatically with inflation. Without indexing, inflation will cause the average income tax rates to rise and income taxes will tend to rise automatically by more than inflation.

²⁵ These arguments are presented in greater detail in Tax Research and Planning Office, Hawaii State Department of Taxation, "Study on the Progressive or Regressive Nature of Hawaii's Taxes," *Op. cit.*, pages 5 and 6.

²⁶ In a letter to the 2001-2003 Tax Review Commission (included in the last two pages of the report), Lowell Kalapa, President of the Tax Foundation of Hawaii, argued that the Commission should consider reducing or eliminating the Corporation Income Tax, on grounds that it contributed little to the State's revenue, but that reducing the rate would "go a long way toward improving the attractiveness of Hawaii as a place to invest and do business."

Recommendation 3

Hawaii should conform to the federal tax treatment of retirement income, excluding an annual base amount (e.g. \$50,000).

Discussion

The current tax treatment is not even-handed, as it distinguishes unfairly between different types of retirement income. There is another equity concern, however, in that people have made employment decisions based on the current tax treatment. For example, some may have accepted smaller government pensions on the expectation that they would not be taxed. People have also made decisions on where to live based on the current tax law. Excluding a base amount would ameliorate the effect of this change on those now receiving tax-free pensions, and remove the effect entirely for those with small pensions (i.e., those below the base exclusion).

The 2001-2003 Tax Review Commission also recommended taxing all pension income, but found that the effect of the current exemption was declining over time, because more people were moving to taxable retirement vehicles (e.g., individual retirement accounts and 401K plans).

Recommendation 4

Hawaii should adopt withholding rules for all nonresident taxpayers involved in pass-through entities, such as partnerships, S-corporations, and limited liability companies.

Discussion

There is much anecdotal evidence that nonresidents are not paying their fair share of Hawaii's taxes and the Commission believes that this measure would encourage greater compliance. It is not intended that the new withholding should apply to trusts or estates.

Recommendation 5

To enforce total tax compliance by nonresidents, the HARPTA withholding rate should be increased and penalties imposed on withholding agents for noncompliance.

Discussion

Currently, when a nonresident sells real property in Hawaii, 5 percent of the gross receipts from the sale are withheld against the potential income tax liability on the gain from the sale. The withholding is referred to as "HARPTA," which stands for "Hawaii Real Property Tax Act." The maximum rate of tax is 7.25 percent on long-term capital gains and 8.25 percent on short-term capital gains, whereas the HARPTA withholding is 5 percent of the gross selling price. It is therefore possible for the income tax liability to exceed the HARPTA withholding, particularly in cases where the property has been depreciated over a long period and the taxpayer has little basis. Furthermore, in some cases the nonresident seller may have been renting the property and neglected to pay Transient Accommodations Tax (TAT) and GET on the rental income. In such cases, the nonresident taxpayer may fail to file an income tax return.²⁷ Increasing the rate of HARPTA withholding will encourage greater compliance by those seeking a refund and it will reduce the State's tax loss for those who continue to fail to file an income tax return.

Recommendation 6



An exchange facilitator or intermediary in an Internal Revenue code section 1031 exchange of properties should be required to remit withholding tax on any shortfall of the amount exchanged, at the withholding rate set by Hawaii on sales of real property by nonresidents.

²⁷ In some situations, particularly if the taxpayer has failed to file Hawaii tax returns, the taxpayer may decide that simply forfeiting the withheld HARPTA amount is preferable to satisfying Hawaii tax obligations. This creates difficulties in enforcement.

Discussion

Hawaii generally follows the federal tax treatment of the gain from sales of real property, so if the gain from sale of real property in Hawaii is exempt from federal income tax under IRC section 1031 as a tax-free exchange of properties, it generally is also exempt from the State's Individual Income Tax. The Commission believes, however, that sellers occasionally receive taxable amounts from such exchanges, either because the exchange fails and the seller merely sells the property in an ordinary sale, or because the seller receives cash or other consideration in addition to eligible property in the exchange. In such instances, the proposal would require the exchange facilitator or intermediary to remit withholding on the taxable amounts at the rate due on sales of Hawaii real property by nonresidents (the "HARPTA" withholding rate).

The Commission also notes that out-of-state lessors too often fail to comply with the State's GET and TAT. It is suggested that the Department of Taxation do more to educate taxpayers and enforce compliance by the out-of-state lessors.

F. RECOMMENDATIONS ON THE ADMINISTRATION OF TAXES

Background

In its review of the administration of Hawaii's taxes, the Commission has relied on input from taxpayers to augment its own expertise, which many of its members have gained from years of conducting active tax practices. We have tempered and seasoned the suggestions from taxpayers by consulting with those within the Department of Taxation who administer the State's taxes. Thus, recommendations represent compromises between conflicting viewpoints and interests. We have tried to steer a course that respects the rights of individual taxpayers, while recognizing the practical constraints imposed by the costs of tax administration.

In addition to the following formal recommendations, the Commission wishes to encourage the Department of Taxation to consider ways to make more of its rulings public for the benefit of taxpayers generally.

Recommendation 1

An extension should be allowed for certification for the high technology credit.

Discussion

The deadline for certification is March 30. The Department of Taxation cannot change the deadline by rule, because it is set by statute. The deadline comes at a bad time for taxpayers. The Commission recommends that if the credit is maintained in its current form, the Legislature provide an extension for certification for convenience of taxpayers.

Recommendation 2

The Legislature should consider the needs of the entire Department of Taxation – not just direct revenue-producing positions such as auditors, but all the divisions within the Department – and they should provide adequate funding to the Department as a good investment for the State.



Discussion

The Commission noted in particular that the Tax Research and Planning Office has not been given resources needed to perform tasks deemed essential by the present Commission, as well as by the Tax Review Commission of 2001-2003. These tasks include the following: (a) Updating its economic models and otherwise improving its ability to help the Council on Revenues to accurately forecast future revenue receipts; (b) analyzing the costs and benefits of special tax credits for ethanol production facilities, investments in high technology and energy conservation expenditures, and of special tax treatment of nonprofit organizations; (c) examining the revenue consequences of conforming Hawaii's income tax laws to the federal income tax

laws; (d) examining the distribution of the burdens of Hawaii's taxes; (e) examining the effects of "bracket creep;" (f) studying the costs of administering Hawaii's taxes; and (g) studying the reasons for fluctuations in the State's Corporation Income Tax.

Recommendation 3

The Legislature should require beneficiaries of tax credits to file truth in disclosure reports in addition to income tax returns.

Discussion

The requirement should apply to all taxpayers, not just individuals. The reports would provide valuable information needed to evaluate the effectiveness of the credits in achieving their goals.

Recommendation 4

Taxpayers should be allowed to make a deposit against future tax liability to stop continued accrual of interest.

Discussion

Tax disputes sometimes involve lengthy administrative proceedings. During such disputes, taxpayers should have the option to make a deposit against future tax liabilities to stop the accrual of interest while the matter is open. The federal government provides for such deposits under section 6603 of the Internal Revenue Code. The need for such deposits arises, because the interest rate charged by the State can greatly exceed the risk-free return available on bank deposits.

Recommendation 5

Hawaii should adopt Internal Revenue Code section 7430, to require the Tax Appeal Court to award court fees where the position of the Department of

Taxation is found to be "not substantially justified," except that the fees should be the actual cost, subject to court approval.

Discussion

The Commission wants to encourage the Department of Taxation to give due consideration to the taxpayer's position and to encourage the Department to seek resolution of cases at an administrative or appeal level to save the taxpayer the costs of defense. The IRC section has a dollar limit on the award of court costs, to prevent taxpayers or their representatives from drawing out litigation and running up the bill. The Commission believes that the IRC limit is too low, and that any award should cover actual costs, unless the court finds them excessive and unreasonable.

Recommendation 6

The Department of Taxation should establish an Appeals Office trained to settle cases, modeled after the Appeals Office of the Internal Revenue Service.

Discussion

The new Appeals Office should be a completely independent branch of the Department of Taxation, reporting directly to the Director of Taxation. It cannot be part of the audit branch, because it must be freely able to disagree with positions taken by the auditors. Furthermore, it should be adequately staffed, so the resolution of cases is not slowed down. The Commission feels the added costs are worth incurring in the long run, both for the benefit of taxpayers and of the Department of Taxation.

Recommendation 7

Repeal the statement in section 232-7 of the Hawaii Revised Statutes, which says that hearings before the Board of Review are public hearings.

Discussion

By statute, the Board of Review hearings are public, but in practice they have been secret inasmuch as no one knows about them. There should be some venue for having a case decided where the taxpayer's returns and tax information remain confidential. Under current procedures, the taxpayer typically presents his case and witnesses and the Department then responds. The Board makes its decision in private; its discussion is not public, nor is it published in any minutes.

IV. CLOSING REMARKS

This concludes the formal report of the 2005-2007 Tax Review Commission. We are honored by the task entrusted to us to evaluate the State's tax structure. Our recommendations are the culmination of many hours of careful work and examination, with invaluable input from the tax community and the public. The Commission held 23 public meetings and had eight in-depth studies performed to examine various important tax policy issues. The studies are presented in the appendices. We sincerely hope you find our recommendations useful in your future deliberations on tax policy.

LIST OF APPENDICES

- Appendix A "Study on the Question 'Is Hawaii's Tax Structure Adequate?'" Tax Research and Planning Office.
- Appendix B "Measuring the Costs and Benefits of Hawaii's Qualified High Technology Business (QHTB) Investment Tax Credit under Act 221 and Act 215," Dr. Marcia Sakai and Dr. Bruce Bird.
- Appendix C "Hawaii's General Excise Tax: Should the Base Be Changed?" Dr. William Fox.
- Appendix D "Study on the Progressive or Regressive Nature of Hawaii's Taxes," Tax Research and Planning Office.
- Appendix E "Study on the Question 'Should Hawaii Replace Its Income and Franchise Taxes With an Increase in the General Excise Tax?'" Tax Research and Planning Office.
- Appendix F "Effects of Increasing the Hawaii Standard Deduction, Expanding the Hawaii Individual Income Tax Brackets, and Enacting a Hawaii Earned Income Tax Credit and Food, Medical Services, and Nonprescription Drug Income Tax Credit," Tax Research and Planning Office.
- Appendix G "Hawaii's Budget Process and Budget Stabilization Funds," Department of Budget and Finance.
- Appendix H "Revenue Costs for Selected General Excise Tax And Use Tax Exemptions and Deductions," Tax Research and Planning Office.
- Appendix I "Summary of Recommendations Made by Tax Review Commissions," Tax Research and Planning Office.

