

LINDA LINGLE
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SENATE COMMITTEE ON WAYS & MEANS

TESTIMONY REGARDING HB 2860 HD 2 SD 2 RELATING TO TAXATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: MARCH 27, 2008

TIME: 9:45AM

ROOM: 211

This bill proposes to exempt aviation fuel purchased from a foreign trade zone from the state general excise and use taxes for fuel used in inter-island air travel.

The House Committee on Economic Development & Business Concerns amended this bill's effective date for purposes of further discussion.

The House Committee on Transportation amended the bill by including the comments of the Department's prior testimony.

The House Committee on Finance passed the bill unamended.

The House of Representatives passed this measure on third reading.

The Senate Committee on Transportation & International Affairs amended this measure to give it a current effective date.

The Senate Committee on Economic Development & Taxation amended this measure to provide a cap on the general excise tax exemption amount.

The Department of Taxation (Department) **supports** this legislation; **however opposes the caps** inserted by the Committee on Economic Development & Taxation.

This bill amends the general excise and use tax law regarding the exemptions from taxation that are currently allowed. Presently, aviation fuel purchased in a foreign trade zone is exempt from state taxation for those flights that are bound for an out-of-state or foreign destination. Because these flights are considered within interstate or foreign commerce, taxation is exempt pursuant to

federal law. There is no corresponding exemption for inter-island flights because these flights are not considered to be in foreign or interstate commerce for tax purposes.

Given the recent bankruptcy filing by a local airline, the Department finds that this legislation is of the utmost importance for the Legislature's consideration in order to assist the local airline industry's struggle with high fuel costs.

I. THE DEPARTMENT OPPOSES CAPS

The Department opposes the cap on the general excise tax exemption because it is unworkable and requests that it be eliminated.

DIFFICULT TO ADMINISTER—Caps on exemptions are difficult to administer. There is an inherent flaw in the cap as currently structured in the proposal. There is an inherent lag between the time returns that are filed; the Department's ability to gather the data and make the determination as to whether the cap was hit; and then making the subsequent announcement to the public. This lag could result in the loss of hundreds-of-thousands-of-dollars in tax leakage due to the inherent lag in tax administration.

ANNOUNCEMENT MECHANISM SUBJECT TO CHALLENGE—The Department appreciates the announcement mechanism; however a taxpayer could argue that they were not "properly advised" or "actually advised" of the cap and challenge any subsequent assessment. The bill should be amended to clearly state that a taxpayer's complaint of lack of notice for an announcement that complies with the statute fails to state a claim for relief. A provision such as this provides the Department with leverage to enforce the cap when the likely first argument from any taxpayer will be that the notice "was not good enough." Issues like this result in litigation and loss of state revenue and resources defending these issues.

UNFAIR TO TAXPAYERS, WHO ARE NOT THE AIRLINES—The cap is also unfair to a company that relies on the exemption because if the cap is hit and an assessment is made after the fact, the seller is the one subject to pay the back taxes when the airline enjoyed the benefit. It is doubtful that the seller could ever recover against an airline once the cap is hit if the exempt amount is passed on.

NO CORRESPONDING USE TAX CAP—The Department points out that the use tax does not have a corresponding cap. The Department is concerned that a large amount of the bill's costs could come from use taxes for certain airlines. Assume an airline that flies both in-state and out-of-state flights, the airline could purchase all fuel under the guise that the fuel is used for its out-of-state flights, which is exempt at the FTZ under the general excise tax. However, if the fuel is later used for in-state flights, the airlines is obligated to pay use tax at that point for the use of the fuel in Hawaii after the fuel loses its exempt character. At a minimum, if the cap is to function properly, the cap must apply equally to both taxes. However, there is an administrative issue that must be confronted because the last time a cap was considered for similar legislation, it could have been interpreted as providing a double benefit—a cap for each type of tax, which circumvented the legislature's intent of one cap for all fuel sales. To avoid this, the Department suggests identifying a

cap to be placed in Chapter 231 that deals with a total exemption under both Chapters 237 and 238. However, the Department strongly prefers no caps at all.

ELIMINATE THE CAP—Without further resources to monitor aviation fuel sales, this cap is unrealistic. Should a cap remain, the Department requests resources in order to implement the cap. The Department requests the caps be eliminated.

II. THE TWO EXEMPTIONS ARE NOT IDENTICAL

The Department points out that the two exemptions are not identical and should be reconciled as follows:

Chapter 237—

"§237- **Aviation fuel for air transportation.** This chapter shall not apply to amounts received from the sale of aviation fuel, as defined in section 243-1, categorized as privileged foreign merchandise, non-privileged foreign merchandise, domestic merchandise, or zone-restricted merchandise that is admitted into a foreign-trade zone and purchased [~~in a foreign-trade zone and is made directly to or is used~~] by a common carrier for consumption or use in air transportation between two points in the State."

Chapter 238—

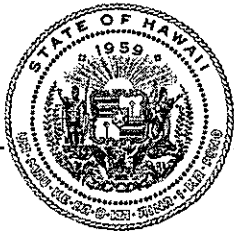
"(12) The use of aviation fuel, as defined in section 243-1, categorized as privileged foreign merchandise, non-privileged foreign merchandise, domestic merchandise, or zone-restricted merchandise that is admitted into a foreign-trade zone and is used by a common carrier [~~by air~~] for consumption or use in air transportation between two points in the State."

III. REVENUE IMPACT.

As amended, this legislation results in an indeterminate revenue impact because of the unspecified cap. However, in absence of the cap, it is the Department's position that this legislation will result in a revenue loss of approximately:

- \$5.1 million loss, FY2009.
- \$5.3 million loss, FY2010.
- \$5.5 million loss, FY2011.

110 million gallons of fuel was sold on Oahu in FY2007. From previous estimates, it was found that approximately 55% of this was of non-exempt fuel. From this, the GE revenues derived from aviation fuel were calculated to be \$4.8 million. This was inflated by CPI_U for the relevant fiscal years.



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Written statement of
MARSHA WIENERT
Tourism Liaison

Department of Business, Economic Development & Tourism
before the

SENATE COMMITTEE ON WAYS AND MEANS

Thursday, March 27, 2008

9:45 a.m.

State Capitol, Conference Room 211

in consideration of
HB 2860 HD2 SD2
RELATING TO TAXATION.

Chair Baker and Members of the Senate Committee on Ways and Means.

The Department of Business, Economic Development and Tourism supports the intent of HB 2860 HD2 SD2, which exempts from general excise and use taxes the fuel sold from a foreign trade zone for interisland air transportation by common carriers and limits the amount of aviation fuel that shall be exempt under chapter 237.

In as much as we support the intent of HB 2860 HD2 SD2 and believe that the interisland carriers should have the same exemptions in general excise and use taxes as airlines traveling out-of-state, we are concerned about the cost implications generated by this proposal.

Thank you for the opportunity to comment on HB 2860 HD2 SD2.



***The Chamber of
Commerce of Hawaii***

Since 1850

Testimony to the Senate Committee on Ways and Means

Thursday, March 27, 2008; 9:45 a.m.

Conference Room 211

SUBJECT: HOUSE BILL 2860, HD2, SD2 – RELATING TO TAXATION

Chair Baker, Vice Chair Tsutsui, and Members of the Committee:

My name is Jim Tollefson and I am the President and CEO of The Chamber of Commerce of Hawaii ("The Chamber"). I appreciate the opportunity to state The Chamber's support of House Bill No. 2860 HD2, SD2, relating to Taxation.

The Chamber is the largest business organization in Hawaii, representing 1100 businesses. Approximately 80% of our members are small businesses with less than 20 employees. The organization works on behalf of members and the entire business community to improve the state's economic climate and to foster positive action on issues of common concern.

The measure, as received by your Committee, exempts from general excise and use taxes the fuel sold from a foreign-trade zone for intrastate air transportation by common carriers.

The Chamber, through its Tourism Committee, encourages a broad base of understanding, support and appreciation for the Tourism and Travel Industries within the business community, Legislature and the general public. The committee also supports visitor industry growth and improvement while working to enhance the visitor experience.

The Chamber understands the value and significance of the airline industry, especially our local carriers, who in addition to serving the travel needs for the people of Hawaii and beyond, have contributed significantly to the community. Any decline in the travel industry harms all businesses and the local economy. As a result, the Chamber wants to embrace and strengthen the commercial aviation sector.

This bill proposes to give fuel tax relief for intrastate air transportation by common carriers. The Chamber believes this is a relevant step in the right direction of giving aid to the industry. Airlines are facing serious challenges today, and exempting them from the general excise and use tax on aviation fuel will help to alleviate some financial burdens. Additionally, this measure provides a fair and balanced relief to the local carriers as well as is consistent with the federal law relating to interstate commerce.

In light of this, The Chamber of Commerce of Hawaii urges you to pass House Bill 2860 HD2, SD2 relating to Taxation, for further discussion.

Thank you for the opportunity to express our views on this matter.

TAXBILLSERVICE

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Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: GENERAL EXCISE, USE, Exempt Foreign Trade Zone aviation fuel

BILL NUMBER: HB 2860, SD-2

INTRODUCED BY: Senate Committee on Economic Development and Taxation

BRIEF SUMMARY: Adds a new section to HRS chapter 237 and a new paragraph to the definition of "use" under HRS section 238-1 to provide that the sales of aviation fuel categorized as privileged foreign merchandise, non-privileged foreign merchandise, domestic merchandise, or zone-restricted merchandise that is admitted into a foreign trade zone and purchased in a foreign trade zone and is made directly to or used by any common carrier for consumption or use in air transportation between two points in the state, shall be exempt from the state's general excise and use tax laws. The exemption shall be limited to \$ _____ per year.

EFFECTIVE DATE: July 1, 2008

STAFF COMMENTS: Currently aviation fuel is imported and stored in Hawaii Fueling Facilities Corporation (HFFC) storage tanks. HFFC was established in 1969 to provide fuel storage and distribution to its member airlines. On September 1, 1997, the HFFC began operating under the Foreign Trade Zone (FTZ) at the Honolulu International Airport. Fuel purchased from HFFC for use in aircraft of HFFC members is exempt from the imposition of the general excise, use, and fuel taxes since they are operating in the FTZ. When the fuel is then pumped through the HFFC's bonded fuel lines and provided to the aircraft, the fuel remains in interstate commerce and technically is outside the jurisdiction of the state and the imposition of state taxes. The current exemption from taxes for product within the FTZ but sold for consumption outside the state applies only when the consumption of such product occurs out of state where sales are made to any common carrier in interstate or foreign commerce.

The purpose clause notes that the rising cost of fuel has added to the challenges of the local airlines and that the cost of the general excise and use tax exacerbates these challenges. Exempting the fuel used for intrastate air transportation would help level the playing field and create a fairer market for all airlines.

While it is the federal law that confers exempt status on products in the FTZ, recognizing that the products have not entered the country, it is understood that the states can further define that recognition with respect to use of products that have FTZ exempt status. This is what this measure proposes with respect to tax laws imposed by the state.

It is curious that the Committee on Economic Development and Taxation added a dollar ceiling on the amount of gross income that would be exempt where no such ceiling was adopted for other incentives approved in prior sessions. Given that inter-island travel is vital to the economic well-being and commerce of this state, why limit the exemption given the rising price of fuel and the viability of these companies?

Digested 3/25/08



A I R L I N E S

March 26, 2008

Senator Rosalyn Baker, Chair
Senator Shan Tsutsui, Vice-chair

Stephanie C. Ackerman
Senior Vice President
Public Relations and
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Facsimile 808 836-0303
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RE: HB 2860, HD2, SD2 Relating to Taxation

Chair Baker, Vice-Chair Tsutsui and Members of the Committee:

My name is Stephanie Ackerman and I am Senior Vice President, Public Relations and Government Affairs, for Aloha Airlines. Thank you for this opportunity to testify in strong support of HB 2860, HD2, SD2.

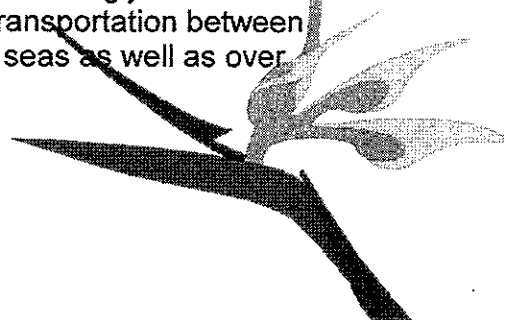
As you well know, Aloha Airlines has once again been forced to seek Chapter 11 bankruptcy protection, which points to the serious financial challenges we face in trying to provide reliable inter-island and transpacific air transportation for Hawaii's people.

For several years now, we have urged the Legislature to revise a state policy that penalizes Aloha and other local airlines unfairly, while extending a tax exemption to our competitors.

The existing statute (Section 212-8) grants a General Excise and Use tax exemption to airlines when they purchase jet fuel from the Hawaii Foreign Trade Zone for flying in interstate or foreign commerce. This is consistent with Federal law governing foreign trade zones and interstate commerce. However, the law is not being applied consistently and as a result, there is discrimination against Hawaii-based air carriers. Legislation is required to ensure that the Hawaii Department of Taxation applies the GET and use tax exemption when airlines purchase fuel from a foreign trade zone for use in interisland flying, which is regulated by Federal law as interstate commerce.

The Commerce Clause of the U.S. Constitution gives Congress sole power to regulate interstate commerce. Contrary to the testimony submitted by the Tax Department that "...court cases conclude that transportation from one point in a state through international territory and back to another point in the same state is not interstate commerce," the U.S. Court of Appeals, Ninth Circuit, in *Island Airlines, Inc. v. C.A.B.*, (352 F.2d 735), held that:

"The high seas over which interisland flights flew while traveling among the various islands of Hawaii, were a "place" within statute defining jurisdiction of the Civil Aeronautics Board over interstate commerce as transportation between points in the same state over a foreign country or high seas as well as over another state."



The Court also cited that the Congress in Senate Committee Report 86-80 on the Hawaii Statehood Act on aviation matters, said:

"Hawaii presents a unique situation with respect to the impact of statehood on the federal regulation of air transportation between the main islands. ...most, if not all, of the interisland air transportation passes through airspace not a part of the territory. ...interstate air transportation, which is defined to include not only transportation between a place in a state and a place in any other state, but also transportation between places in the same state through the airspace over any place outside thereof.. **...with the admission of Hawaii as a state, interisland air transportation will remain subject to the economic controls provided by the Federal Aviation Act including other applicable federal legislation, because that transportation, or most of it, while between places in the same state, will pass through airspace outside the state.** In the other states, air transportation of this kind passing through airspace outside the state of slight volume in comparison with air transportation merely between places in the same state. **...the Committee wishes to make it clear that ...the provisions of the Federal Aviation Act and other applicable federal legislation to the State of Hawaii should continue in accordance with the definition of interstate air transportation as contained in that Act."**

Title 49 U.S. Code, section 40102 (Federal Aviation Act) specifically defines "interstate air transportation" as "the transportation of passengers or property by aircraft as a common carrier for compensation, or the transportation of mail by aircraft ...between a **place in Hawaii and another place in Hawaii through the airspace over a place outside Hawaii."**

As we understand it, Federal law preempts the State from imposing GET on the sale of fuel from a foreign trade zone when the fuel is used in interstate commerce, which includes points within the State of Hawaii.

With that in mind, we return to the equity issue. We believe that ALL flights operated by common carriers must be considered interstate transportation; therefore the GET exemption on fuel must apply to ALL of them equally. H.B. 2860, HD2, SD2, discriminates against interisland air carriers, which are considered interstate air transportation, by limiting the GET exemption in violation of the Commerce Clause of the U.S. Constitution.

We request that you remove the cap on exemptions and restore the bill to the form of H.B. 2860, HD2, SD1. Now is the time to show your support for local airlines.



**TESTIMONY OF KEONI WAGNER ON BEHALF OF HAWAIIAN AIRLINES
IN SUPPORT OF H.B. NO. 2860, HD 2, SD 2, RELATING TO TAXATION**

March 27, 2008

To: Chairperson Rosalyn Baker and Members of the Senate Committee on Ways and Means:

My name is Keoni Wagner and I am the Vice President for Public Affairs for Hawaiian Airlines presenting this testimony on behalf of Hawaiian Airlines in strong support of H.B. No. 2860, HD 2, SD 2.

This bill provides an exemption from state general excise and use taxes on fuel purchased from a foreign trade zone (FTZ) and used for interisland air transportation within the State of Hawaii. The state currently exempts from these taxes all fuel sold from an FTZ that is used for flights between Hawaii and the mainland or international destinations. We continue to believe that this same exemption should apply to interisland flights and respectfully request that legislation be passed to make this exemption more explicit.

Thank you for the opportunity to testify on this measure.