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HOUSE COMMITTEE ON FINANCE

TESTIMONY ON SB 971 SD 2
RELATING TO CONFORMITY OF THE HAWAII INCOME TAX LAW TO THE INTERNAL REVENUE CODE

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: MARCH 25, 2009
TIME: 3PM
ROOM: 308

The purpose of this bill is to amend Hawaii's income tax law to conform with the changes to the Internal Revenue Code (the "Code") made by Congress in 2008.

The Department of Taxation ("Department") **supports the conformity amendments**; however has **strong concerns regarding the taxation of pension income**.

SUBSTANCE OF THE MEASURE ALREADY HEARD—The Department supports the amendments to the conformity statutes as provided in the original version of this bill and its House accompanying measure, HB 1153.

Because an identical version of the substantive amendments to conformity statutes was already heard in this committee, the Department limits its comments to the nonconformity amendments made by WAM relating to pension income.

TAXATION OF RETIREMENT INCOME—This measure was amended by WAM to tax government and private employer-funded pension income in excess of $50,000. WAM revised section 3 of SB 971, SD1 to amend subsection (n) of section 235-2.4, HRS, to provide that sections 410 to 419A of the Internal Revenue Code (the "Code") are operative, "*provided that, except for the first $50,000, each year, employer paid pension income shall be taxable under this chapter.*"

Currently, there is a disparity in Hawaii's income tax law relating to the taxation of retirement income. The retirement income of all government and Employee Retirement System (ERS) participants is entirely exempt from income taxation. Also, all employer contribution "pension" income is exempt from income taxation.

The disparity in retirement income taxation arises due to the modern shift from true pension income retirement plans to self-managed retirement plans, such as 401(k) plans and

Individual Retirement Accounts. The income distributions from these latter plans that are from employee savings are fully taxable for Hawaii income tax purposes. Because of the shift from employer pensions to privatized retirement accounts in the private sector, there are fewer retired individuals that qualify for Hawaii income tax exemption for retirement income than in years past. The intent of Hawaii's retirement income tax exclusion was to minimize the financial burden on retired persons, who are typically living on fixed-income and in a more vulnerable financial position.

STRONG CONCERNS REGARDING TAXING CURRENTLY-EXEMPT PENSION INCOME— This legislation results in a tax increase for public workers that have worked diligently relying upon a lower salary in exchange for tax-free pension income when they retire from government work. Effectively, this bill only exempts the first $50,000 of Employee Retirement System (ERS) income from state tax. All other ERS benefits will be considered taxable after this amount. Because government workers have been enticed to remain on-the-job and not seek highly competitive private sector work on the presumption that any retirement benefits will be tax free, this legislation is inappropriate.

The same argument holds for persons that receive "traditional pension" income. There are few employers that offer pension income, as defined for Hawaii tax purposes. Pension income is any income provided by an employer as payment for past services. Employees fortunate enough to have a fixed pension stream of income have likewise also accepted a lower salary over their lifetime in exchange for a tax-free annuity; except for retired CEO's and other management. This legislation also caps this tax exemption that these private sector employees and employers have relied upon.

Ultimately, the number of persons that would be impacted by this measure is yet to be determined; however this measure could be the slippery slope that leads to all-out taxation of pensioners who worked for a lower salary in hopes of a tax free retirement.

SUPPORTED BY THE TAX REVIEW COMMISSION—The Department points out that the concept of this measure was supported by the Tax Review Commission, which essentially suggested that there be a cap on the amount of tax free income. In its Recommendation 3, the Tax Review Commission found:

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

The Commission essentially recognized the disparity in taxation of similar income discussed above.

ANY AMENDMENTS TO THE TAXATION OF RETIREMENT INCOME MUST BE REMOVED FROM THIS BILL—The Department urges the Committee to eliminate any reference to state and local taxation in what is strictly a federal conformity measure. The annual conformity measure must pass without political influence because Hawaii is a conforming jurisdiction and must amend its laws to conform to federal amendments. If the annual conformity measure is not passed, the disparity between Hawaii and federal income tax administration will be very burdensome for taxpayers and the government.

AMEND HRS §§ 88-91 and 235-7—Currently, this bill amends Sections 410 to 419A of the Code, which address special rules that deferred compensation plans (*e.g.*, pension, profit-sharing, stock bonus plans) must satisfy to constitute qualified plans and do not address the taxability of distributions from such plans. Accordingly, it is inappropriate to include the provision to tax employer paid pension income in excess of $50,000 each year in subsection (n) of HRS section 235-2.4.

To accomplish the intent to tax employer paid pension income in excess of $50,000, sections 235-7(a)(2) and (a)(3), HRS and section 88-91, HRS would need to be amended.

REVENUE IMPACT—The retirement income portion of this measure will result in a revenue gain of $10,236,128.

Provisions in the original bill have the following revenue impacts:

- "Heartland, Habitat, Harvest, and Hort. Act of 2008" (P.L. 110-246): $13,950
- "Emergency Economic Stabilization Act of 2008" (P.L. 110-343): ($163,125)
- "Energy Improvement and Extension Act of 2008" (P.L. 110-343): ($161,550)
- "Tax Extenders and AMT Relief Act of 2008" (P.L. 110-343): ($1,653,311)
- "Housing Assistance Tax Act of 2008" (P.L. 110-289): ($120,832)
- "Worker, Retiree, and Employer Recovery Act of 2008" (P.L. 110-458): ($1,351,775)

In its current version, the total net revenue impact (*i.e.*, the taxation of retirement income minus the costs of conformity) is a revenue gain in FY2010 of $6,799,485.

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Testimony of

Thomas Smyth, State Legislative Chair

Military Officers Association of America, Hawaii Chapter

Before the House Committee on Finance

Wednesday, March 25, 2009, 3:00pm, Room 308

On SB 971 SD2

Relating to Conformity of the Hawaii Income Tax Law to the Internal Revenue Code

Chair Oshiro, Vice Chair Lee and Members of the Committee:

Our association of retired and currently serving officers of the seven Uniformed Services understands the intent and purpose of SB 971, but has strong concerns with one section of the bill as amended in SD2.

Section 3(n), page 10, lines 1-3 creates an entirely new income tax for "employer paid pension income" beyond the first $50,000. This provision was added in SD2 without any opportunity for public testimony and with little committee discussion. Many of those directly affected may still not be aware of this added tax on our older residents, since it is in the midst of so many necessary and required conformity issues. It has not been listed in news articles on new tax legislation.

Certainly this bill is needed more than ever this year, given all the IRC changes made in 2008. However our more than 500 members, most of whom are receiving pensions for their long years of military service and sacrifice, do not feel it is right to suddenly tax some or all of their pensions.

It is also not clear just what pension income is to be taxed. Since the employer pays 50% of FICA, the basis of Social Security Income, is that to be taxed? Are pensions funded from retirement plans that are partially funded by employers also taxed? We feel these questions are important since many receive more than one pension that could move the total above

the taxable threshold. It is also not clear if the threshold is the same for the various categories of filers: single, married head of household, etc.

We urge this committee to give very serious consideration to this provision of the bill. There should be far greater transparency for this new tax. There are many pensioners who retired in Hawaii, in part, even large part, because their pensions are not taxed by the state. There will be a significant loss of these valuable community members who so often contribute their time and talent in helping all of us, if this benefit is suddenly and retroactively, taken away.

Thank you for the opportunity to provide this testimony.