LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

KURT KAWAFUCHI
DIRECTOR OF TAXATION

STANLEY SHIRAKI
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

SENATE COMMITTEE ON WAYS & MEANS
TESTIMONY REGARDING SB 2749
RELATING TO TAX CREDITS

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: FEBRUARY 10, 2010
TIME: 9:30AM
ROOM: 211

This measure clarifies that application of tax credits used to offset income tax liability by requiring that refundable credits be used first; followed by nonrefundable credits.

The Department of Taxation (Department) **strongly supports** this measure.

PROVIDES FOR BUDGETING CERTAINTY—The Department supports this measure because of the budgeting certainty it provides. The purpose of this measure is to ensure efficient administration of Hawaii tax credits. Currently, there is no statutory ordering of the overall use of tax credits to offset tax liability. This measure will provide relief to the general fund, as well as additional certainty in terms of financial impact by requiring that refundable income tax credits must be used first to offset tax liability; followed by nonrefundable income tax credits. By requiring refundable credits to be used first, the likelihood that the general fund must payout additional revenues to taxpayers in any given year beyond reducing tax liability to zero is substantially reduced.

NO MATERIAL FINANCIAL LOSS TO TAXPAYERS—In the Department's perspective, taxpayers' only financial loss is the time value of money. In most instances, taxpayers will not lose any credit,[1] they will only have to use them in future tax years. Taxpayers will be required to use refundable credits first to offset tax liability; followed by nonrefundable credits. Credits that may be carried forward are allowed to be carried forward indefinitely. Taxpayers that have additional refundable tax credits beyond tax liability will still receive a refund.

---

[1] Most nonrefundable credits can be carried forward indefinitely. The tax credit for taxes paid to another state; however, is an example of a tax credit that cannot be carried forward indefinitely.

EXAMPLES—Below are examples of the impact of this measure:

Examples	Effects on			No Effect on				
	1	2	3	4	5	6	7	8
Current								
Tax Before	10	10	10	10	100	10	10	10
Non-Refundable Credit	80	15	30	2	0	25	12	0
(can't be below zero)	20	0	70	8	100	75	0	10
Refundable Credit	80	3	15	2	2	0	0	12
Tax Owe (or Refund) After Credits	(60)	(30)	(80)	6	7	75	0	(25)
Carryforward or	0	(50)	0	0	0	0	(25)	0
Proposed								
Tax Before	10	10	10	10	100	10	10	10
Refundable Credit	80	3	15	2	2	0	0	12
	20	7	(50)	8	7	10	10	(25)
Non-Refundable Credit	80	15	30	2	0	25	12	0
Tax Owe (or Refund) After Credits	0	0	(50)	6	7	75	0	(25)
Carryforward or	(60)	(80)	(30)	0	0	0	(25)	0

REVENUE GAIN—This measure will result in a general fund revenue gain of approximately $17 million for at least two years.

L E G I S L A T I V E

TAXBILLSERVICE

126 Queen Street, Suite 304 TAX FOUNDATION OF HAWAII Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Ordering of credit claims

BILL NUMBER: SB 2749; HB 2596 (Identical)

INTRODUCED BY: SB by Hanbusa by request; HB by Say by request

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to provide that the use of an income tax credit in the offsetting of a taxpayer's income tax liability shall first be given to refundable tax credits, followed by nonrefundable tax credits.

EFFECTIVE DATE: Tax years beginning on or after January 1, 2010

STAFF COMMENTS: This is an administration measure submitted by the department of taxation TAX-09(10). This measure statutorily prioritizes the use of tax credits by specifying that refundable tax credits, then nonrefundable tax credits shall be applied against a taxpayer's income tax liability.

Generally, taxpayers have been allowed to utilize nonrefundable tax credits to which they were entitled to offset their tax liability first, and then to claim the refundable tax credits due to them to further reduce their tax liability. Thus, any excess amount of tax credits were due to the refundable credits. By directing taxpayers to utilize their refundable tax credits first, then the nonrefundable tax credits to further reduce tax liability insures that if there are credit amounts in excess of liability, they are nonrefundable credits. This would reduce the payout of excess refundable credits and thus ameliorate the state's general fund cash flow.

It should be noted that many of the refundable tax credits are granted because the taxpayer is in a low income category and thus, the credit represents a refund of taxes paid such as the food/excise and low-income renter credits which are intended to be a refund of the general excise taxes paid on those purchases thereby mitigating the regeressivity of the general excise tax. For business taxpayers, the capital goods excise tax credit is a refund of the 4% general excise tax paid on the purchase of capital equipment. While it is doubtful that a low-income taxpayer would have any of the nonrefundable tax credits, a business may have some of those credits.

Since all of these credits are charges against the income tax which is a contributor to the state general fund, refunds of credit are a direct hit on the cash flow of the general fund. Thus, mandating that refundable credits be applied first to tax liability and then nonrefundable tax credits be applied might ease the cash paid out of the general fund.

It should be noted that there is an idiosyncracy with respect to the fuel tax credit for commercial fishers. When the provision was adopted in 1981, the intent of the measure was to refund commercial fishers the fuel tax paid on their purchases of fuel. However, because it is claimed on the income tax, the refund is a charge against the general fund as opposed to the transportation special fund into which fuel taxes are deposited. If this credit is to be continued, consideration should be given to charging this credit against the transportation special fund. It should be noted that when farmers apply for a refund of fuel taxes for fuel for off-highway use, the refund is paid from the highway special fund.

While the measure provides that refundable tax credits shall be utilized first and result in the taxpayer receiving a refund, it is questionable why the justification sheet states that the adoption of this measure would result in a revenue gain of $17 million for at least two years. Finally, if this issue is only now taking center stage, lawmakers need to remind themselves that this situation is of their own making, particularly in recent years when lawmakers adopted numerous targeted business tax credits all in the name of encouraging economic development and energy self-sufficiency. As the last two Tax Review Commissions have recommended, lawmakers need to undertake a critical evaluation of these targeted business tax credits and consider repealing them sooner rather than later.

Digested 2/4/10