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To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Tuesday, April 5, 2016
Time: 2:15 P.M.
Place: Conference Room 308, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.C.R. No. 91 / H.R. No. 52, Requesting the Tax Review Commission to Conduct a Study on the Feasibility of Using a Percentage of a Taxpayer's Federal Individual Income Tax to Calculate the Taxpayer's State Individual Income Tax, and to Determine Why the Current State Individual Income Tax Appears to be Relatively Regressive, Compared to the Federal Individual Income Tax, with Regard to Taxpaying Households of Median and Lower Incomes in Hawaii.

The Department of Taxation (Department) appreciates the intent of H.C.R. No. 91 / H.R. No. 52, and offers the following comments for your consideration.

H.C.R. No. 91/H.R. No. 52 requests the Tax Review Commission (TRC) to conduct a study evaluating the use of a percentage of federal individual income tax in place of the current state individual income tax and to determine why Hawaii's state individual income tax is regressive compared to the federal individual income tax.

Specifically, the resolution requests the TRC to study the following three items: (1) the feasibility of using a percentage of a taxpayer's federal individual income tax as their Hawaii individual income tax; (2) how certain features of Hawaii's income tax, like the pension exclusion, could be retained if such a system were used; and (3) why Hawaii's individual income tax is regressive compared to the federal individual income tax. A report on the study is due to the legislature twenty days before the Regular Session of 2017 is convened.

The TRC is a commission which is administratively attached to the Department. The Department will provide support to the TRC and assist in the requested study to the extent that resources permit. However, the Department has several concerns about the descriptions and comparisons of federal and Hawaii income tax in the resolution.

First, the Department notes that the language of the resolution does not directly compare federal and state tax liabilities but instead compares federal refund amounts, which take account of federal withholding and the earned income tax credit, to state income tax liabilities that do not take account of withholding. Comparing the two tax systems in this way exaggerates the difference in burden between the two. The proper comparison would be the federal tax liability against the Hawaii tax liability ignoring any withholding and all credits.

For example, the resolution describes a typical family of four with adjusted gross income of $40,000. The resolution states this family would receive a federal income tax refund of $1,974, however, the resolution does not state the taxpayer's tax liability or how much income tax was withheld. This is important because, to receive a refund, the taxpayer must have paid in through withholding more than the tax liability. The resolution then states that the same taxpayer would owe Hawaii income tax of $1,469. This does not take account of the taxpayer's withholding for state income tax. Because the resolution is not uniformly accounting for withholding, the resolution overstates the impact of the Hawaii income tax.

If the Legislature wishes to advance this resolution, the Department recommends the study compare federal and state income tax liabilities directly in studying the feasibility of using a percentage of the federal individual income tax as the state individual income tax.

Second, the Department notes the resolution supposes a system where, as in the Alaska proposal, the taxpayer would simply write a check for the total amount of state tax after determining federal income tax liability and applying the percentage. If this payment method were used, compliance and collection rates would decrease. This is because it is always easier to collect tax through periodic payments, specifically through withholding from wages, than to expect taxpayers to make lump-sum payments.

Third, the Department notes that the Department of the Attorney General has raised constitutional issues over attempts to automatically conform to an outside body of law. The proposal would base Hawaii's income tax on a percentage of the federal income tax refund or liability. This would create automatic conformity to the federal income tax rates, deductions, personal exemptions, and tax credits. The Department defers to the Department of the Attorney General as to the constitutionality of the proposed income tax structure in this resolution.

Fourth, the Department notes that S.B. 2922 extends the deadline for the TRC to submit its report to the Legislature from thirty days prior to the 2017 regular session to thirty days prior to the 2018 regular session. The Department suggests amending the due date of the report contemplated in this resolution accordingly.

Finally, the Department notes that a study of the incidence of income tax on low to middle income individuals is important; however, the Department believes that the more appropriate feasibility study would focus on Hawaii income tax rates, standard deductions, and personal exemptions. Making amendments to the Hawaii tax laws that set these amounts, instead of automatically conforming to federal laws, will make it easier for the Legislature to perform budget forecasting.

Thank you for the opportunity to provide comments.