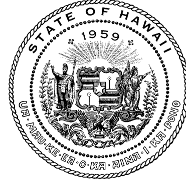
DAVID Y. IGE
GOVERNOR

SHAN TSUTSUI
LT. GOVERNOR



MARIA E. ZIELINSKI
DIRECTOR OF TAXATION

DAMIEN A. ELEFANTE
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809
PHONE NO: (808) 587-1540
FAX NO: (808) 587-1560

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

Date: Thursday, February 9, 2016
Time: 2:00 P.M.
Place: Conference Room 308, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.B. 145, Relating to Net Income Tax

The Department of Taxation (Department) appreciates the intent of H.B. 145, and offers the following comments for your consideration.

H.B. 145 limits the amount of itemized deductions allowed to a taxpayer based on federal adjusted gross income (FAGI). For taxpayers filing jointly with FAGI of $100,000 or less, the maximum amount of itemized deductions is equal to the taxpayer's FAGI. For taxpayers filing jointly with FAGI above $100,000, the maximum amount is $100,000 reduced by 25 per cent of the amount of the taxpayer's FAGI that exceeds $100,000. For taxpayers filing jointly with FAGI of $500,000 or more, the maximum amount is zero.

The limits apply to single taxpayers as well but at exactly half the FAGI levels. For head of household filers the thresholds are $75,000 and $375,000. In addition, H.B. 145 disallows the deduction for state sales taxes in lieu of state and local income taxes. The bill also repeals the limit on the state and local income tax deduction and allows corporate taxpayers to claim it. H.B. 145 applies to taxable years beginning after December 31, 2016.

First, the Department recommends amending the bill to use Hawaii adjusted gross income (HAGI), rather than FAGI, for purposes of the limitation thresholds. This recommendation is for both consistency and for equity. References to adjusted gross income in Hawaii's income tax law are references to HAGI unless otherwise stated. Therefore, HAGI is used for purposes of the section 68, Internal Revenue Code (IRC) limitations on itemized deductions. The use of differing measures for the two limitations may lead to difficulty of administration and taxpayer confusion.

In addition, the use of FAGI will lead to inequitable treatment between taxpayers with identical FAGI. As written, a taxpayer with FAGI of $100,000 or less may claim itemized deductions equaling an amount up to their FAGI. However, those itemized deductions are

deducted from HAGI, not FAGI. FAGI is only the starting point in determining HAGI; Hawaii requires additions to and subtractions from FAGI to arrive at HAGI. A taxpayer who has Hawaii additions to FAGI will face a limit that is less than HAGI, while a taxpayer with the same FAGI who has Hawaii subtractions from FAGI will face a limit that exceeds HAGI.

For the two reasons discussed above, the Department recommends amending the bill to use HAGI rather than FAGI. This can be done by removing the reference to “federal” and leaving only a reference to “adjusted gross income.”

Second, the Department notes that in previous limits to itemized deductions (Act 97, SLH 2009, as amended by Act 256, SLH 2013) the deduction for charitable contributions was excluded from the limitations. This carve-out expired with the previous limitations. H.B. 145 contains no such carve-out. If it is the Committee's intent to exclude deductions for charitable contributions from the proposed limits, then that exclusion should be included in the bill.

Third, the Department notes that the disallowance of the deduction for state sales taxes in lieu of state and local income taxes is unlikely to affect many taxpayers in Hawaii. This is because this provision of federal law is intended to provide a deduction to residents of states with no state income tax. In states with an income tax, such as Hawaii, it is expected that residents will deduct their state income tax paid in most cases.

Fourth, the Department notes that the repeal of the limits on the state and local income and sales tax deduction will simplify tax administration and reduce confusion among taxpayers. It is also unnecessary to have limitations on specific deductions with an overarching limitation on total itemized deductions as this measure proposes.

Fifth, if this measure is adopted, the Legislature may want to consider making section 68 of the IRC inoperative for Hawaii. In most cases, the limitations proposed in this measure will be more restrictive than the section 68 limitations. Simplifying the calculation of the limitations will promote taxpayer compliance and ease of administration for the Department.

Finally, if the Committee wishes to move this measure forward, the Department requests that it be made applicable to taxable years beginning after December 31, 2017. This will allow sufficient time to make the necessary form, instructions and computer system changes.

Thank you for the opportunity to provide comments.

TAX FOUNDATION OF HAWAII

126 Queen Street, Suite 304 Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Restore State Tax Deduction, Increase Pease Limitation

BILL NUMBER: HB 145

INTRODUCED BY: LUKE

EXECUTIVE SUMMARY: In accordance with a research paper published in 2014, restores the deduction for state taxes paid that was permanently taken away by Act 97, SLH 2011; but provides a maximum amount of itemized deductions that can be taken, as a function of federal adjusted gross income (FAGI).

BRIEF SUMMARY: Amends HRS section 235-2.4 to restore the deduction for state taxes paid, and provides that the maximum amount of itemized deductions allowed shall be:

Filing Status	Taxpayers' Federal AGI	Maximum Allowable Itemized Deductions
MFJ or Surviving Spouse	$100,000 or less	Amount of FAGI
	$100,000 to $500,000	$100,000 – 25%(FAGI – $100,000)
	$500,000 or more	-0-
Single	$50,000 or less	Amount of FAGI
	$50,000 to $250,000	$50,000 – 25%(FAGI – $50,000)
	$250,000 or more	-0-
Head of household	$75,000 or less	Amount of FAGI
	$75,000 to $375,000	$75,000 – 25%(FAGI – $75,000)
	$375,000 or more	-0-

EFFECTIVE DATE: Upon approval, applies to taxable years beginning after December 31, 2016.

STAFF COMMENTS: A team of three authors, Terrance Jalbert of UH-Hilo, Gary Fleischmann at Texas Tech University, and Mercedes Jalbert of the Institute for Business and Finance Research in 2014 published a paper called "Marginal Tax Rates Around the Hawaii Itemized Deduction Cliff." That paper points out that when a Hawaii taxpayer reaches $200,000 in federal adjusted gross income, several bad things happen that, in total, could result in a marginal tax rate of 367,100% on that last dollar at that time. Business news services, such as Forbes, picked up on the study, and the picture they painted wasn't good.

So what are these "tax cliffs?" At the time, there were three of them. First, the one dollar of income from $199,999 to $200,000 (assuming a taxpayer is married and filing jointly) triggers a

loss of the entire deduction for the state taxes they have paid. Second, that same dollar triggers a hard cap on any other itemized deductions they may have (mortgage interest, medical, etc.), so that any itemized deductions other than state taxes (which are disallowed by the first provision) or charitable contributions (which were saved from the jaws of this provision in 2013) in excess of $50,000; are lost. (This hard cap on itemized deductions expired at the end of 2015.) Third, any remaining itemized deductions are reduced by three percent for each dollar of federal AGI in excess of $166,800. This third provision is not triggered by the 200,000th dollar, but it magnifies the overall effect of the first two provisions.

The authors of the study recommended an overall limitation on itemized deductions as a function of FAGI, which this bill implements.

The full study from the journal *Accounting and Taxation* can be accessed at:
http://ssrn.com/abstract=2408302

Digested 2/7/2017