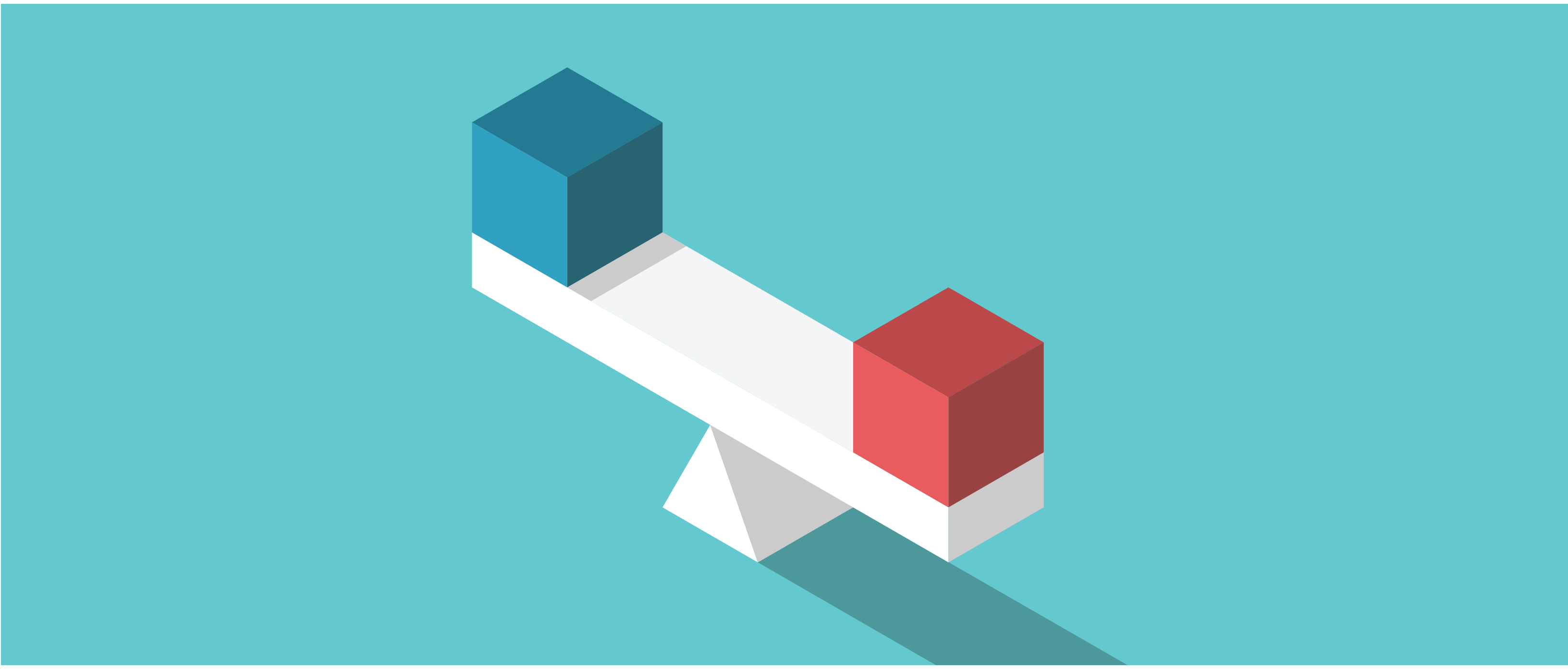
# Review of General Excise and Use Tax Exemptions and Exclusions

## A Report to the Legislature of the State of Hawai‘i

**Report No. 20-09**
June 2020



**OFFICE OF THE AUDITOR**
STATE OF HAWAI‘I

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# Foreword

This report assesses certain tax exemptions and exclusions from Hawai‘i's General Excise Tax and Use Tax. Section 23-71 et seq., Hawai‘i Revised Statutes, requires the Auditor to annually review different tax exemptions, exclusions, and credits on a 10-year recurring cycle, including provisions for the Public Service Company Tax and Insurance Premium Tax. This report is our first review under these statutes.

We express our appreciation to the Department of Taxation for its cooperation and assistance. In addition, we thank the Department of Business, Economic Development and Tourism, the Department of Commerce and Consumer Affairs, the Department of Labor and Industrial Relations, the Department of Transportation, the Legislative Reference Bureau, the Public Utilities Commission, and the Tax Foundation of Hawai‘i for their assistance in providing data and other information for this report.

Leslie H. Kondo
State Auditor

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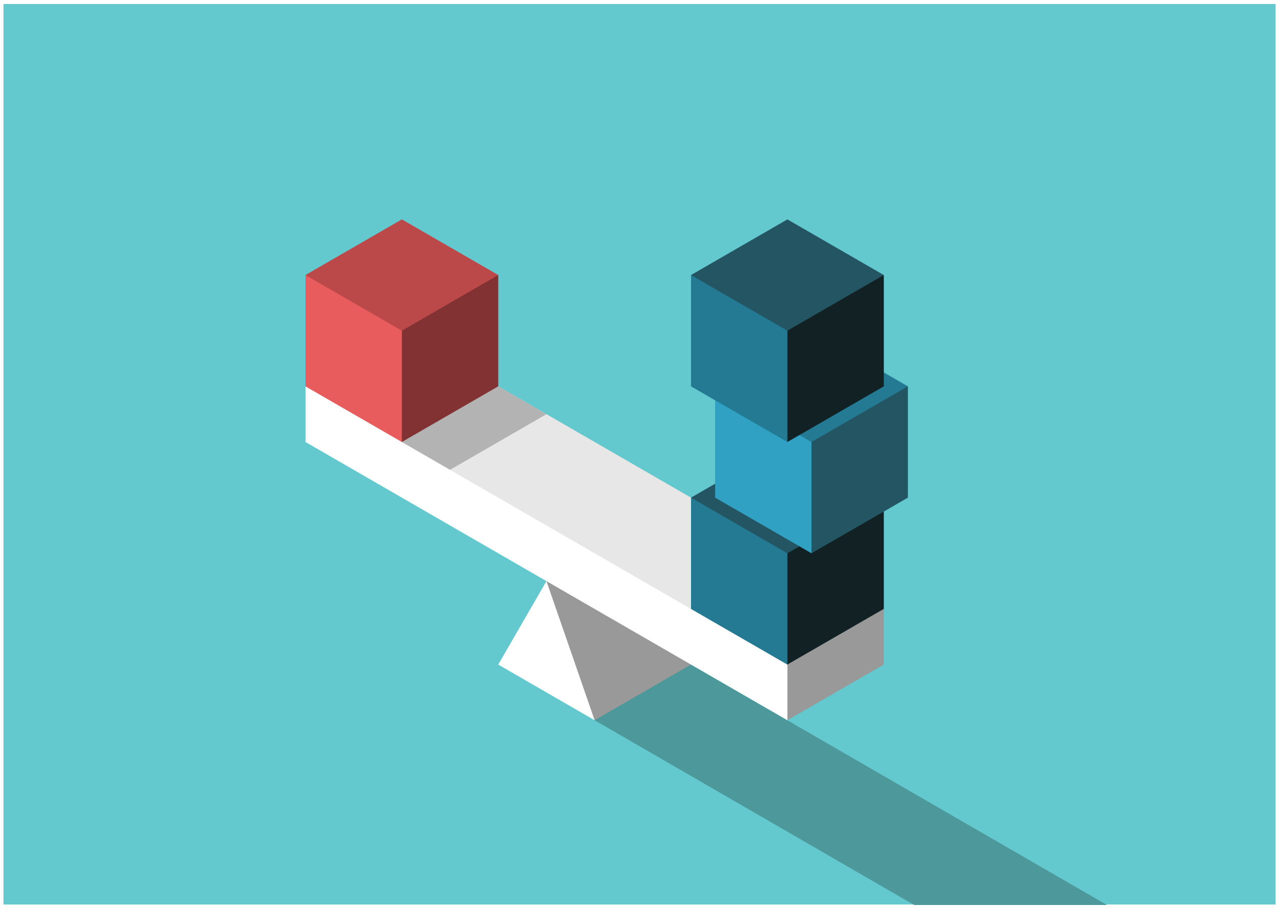

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# Review of General Excise and Use Tax Exemptions and Exclusions

## Introduction

THIS REPORT assesses certain tax exemptions and exclusions from Hawai'i's General Excise Tax (GET) and Use Tax. Section 23-71 et seq., Hawai'i Revised Statutes (HRS), requires the Auditor to annually review different tax exemptions, exclusions, and credits on a 10-year recurring cycle, including provisions for the Public Service Company Tax and Insurance Premium Tax. Appendix A includes the full list of tax provisions required to be reviewed each year of the 10-year cycle, which began in 2019.

Beginning in 2020, we also will annually review credits, exclusions, and deductions provided under the Income Tax and Financial Institutions Tax on a five-year recurring cycle that was established under Section 23-91 et seq., HRS. The complete list of tax provisions that will be reviewed during each year of that cycle is also included in Appendix A.

**The analysis and recommendations in this report aim at better informing policymakers about the purposes, costs, and benefits of various GET and Use Tax provisions to allow for improved policymaking.**

## About This Report

As described by the Department of Taxation (DoTax), Hawai‘i's GET and Use Tax, combined, apply to nearly all business activities in Hawai‘i, resulting in a $111 billion tax base. In FY2018, GET and Use Tax revenues accounted for $3.55 billion, or 31 percent of the State's total revenue of $11.32 billion. Notwithstanding, lawmakers may choose to exempt or exclude certain revenues from taxation to promote certain social and economic goals. Since these exemptions and exclusions reduce revenues to the State, the analysis and recommendations in this report aim at better informing policymakers about the purposes, costs, and benefits of various GET and Use Tax provisions to allow for improved policymaking.

Section 1 of Act 261, Session Laws of Hawai‘i (SLH) 2016, which established the annual review of tax exemptions, exclusions, and credits by the State Auditor's office, noted that tax expenditures from exemptions, exclusions, and credits reduce revenues to the State. This requires ordinary taxpayers who do not benefit from the exemptions, exclusions, and credits to compensate for the reduced revenues, or alternately, funding for important state programs must be curtailed. However, the Legislature also believed that certain tax exemptions, exclusions, and credits are worthy of continuation for equity, efficiency, and economic and social policy.

Accordingly, the Legislature found these reviews are "necessary to promote tax equity and efficiency, adequacy of state revenues, public transparency, and confidence in a fair state government."

This report reviews 13 tax provisions: 6 GET and Use Tax exemptions and 7 GET exclusions.[1] Overall, we found, with one exception, there is insufficient data to determine whether the *exemptions* reviewed are meeting their stated or inferred purposes. We recommend the one exemption that is not achieving its purpose be repealed and the Legislature consider including clearly articulated purposes along with specific metrics for measuring effectiveness in all new or amended tax preferences. As noted throughout this report, we struggled to determine the purposes of the provisions reviewed, and in some cases, were unable to even infer the purposes. Additionally, we had no objective means to assess whether provisions were achieving their purposes. Including clearly stated purposes for each tax provision and metrics for us to assess performance will permit a more thorough and meaningful analysis of exemptions. We further recommend that all seven *exclusions* be removed from the schedule of future reviews. As explained below, the exclusions represent revenue that was never intended to be subject

[1] We discuss the differences between tax *exemptions* and tax *exclusions* at page 4.

to GET. Taxpayers, generally, are not required to have a GET license or to file a GET return to benefit from the exclusions. For that reason, DoTax does not compile information about the use of many of these exclusions.

## Hawai‘i's General Excise Tax and Use Tax

Hawai‘i's GET and Use Tax have broad reach – together, they apply to nearly every business transaction conducted in the State as well as to goods and services imported to Hawai‘i from other states and foreign countries. The two taxes are complementary to each other. GET is paid by a person or entity that receives income from doing business in the State, while Use Tax is paid by a person or entity importing goods, services, or contracting into the State from sellers who are *not* subject to GET. The Use Tax is intended to level the tax playing field by taxing goods and services that are purchased outside of Hawai‘i and imported for use or resale. The Use Tax attempts to remove any tax advantage that businesses outside of the State may have with respect to goods and services used in Hawai‘i.

**General Excise Tax (Chapter 237, HRS)**
According to DoTax, businesses pay GET for the privilege of doing business in the State of Hawai‘i. GET is imposed on the *gross* income received by the entity (individuals, corporations, partnerships, or other entities) engaging in business activity in Hawai‘i, which includes revenues from wholesaling, retailing, farming, services, construction contracting, rental of personal property, and business interest income.

While GET is regarded as a tax on gross business income, it resembles a consumption tax or sales tax in that the cost is typically passed along to consumers. However, GET is distinct from a typical sales tax in that it is a tax *on the business*, whereas a sales tax is a tax *on the consumer* that is collected by the business. GET is also distinct in that it is assessed on every business transaction – wholesale and retail – resulting in a broad tax base. By contrast, a typical sales tax only applies to retail sales of tangible goods.

### Tax Like an Egyptian:

The wholesale rate, the retail rate, and tax "pyramiding"

**HAWAI‘I'S GET** is applied to the gross receipts or gross income from business activities in the State, including both wholesale and retail transactions. This is in contrast to a sales tax, which is typically taxed only at one level – the point of sale. The imposition of GET on business transactions at all levels results in what is commonly referred to as tax "pyramiding" – essentially tax on tax – with tax being imposed at various points on the same goods or services as they move through the chain of production and distribution to the eventual consumer. Having a tax on a tax results in higher total costs and provides an incentive for firms to consolidate operations in order to avoid taxes. For example, a car manufacturer incorporates an engine purchased from another company into its final product; GET is paid by the engine seller, which includes that tax payment in the amount it bills to the manufacturer, and again by the manufacturer on the revenue it receives when the automobile is sold. To avoid the additional cost to the consumer caused by the pyramiding of GET the manufacturer may decide to build the engines in-house.

In order to reduce the effects of tax pyramiding, Hawai‘i imposes a lower rate – 0.5 percent – on wholesale or business-to-business transactions of goods or services intended for resale. The retail rate – 4 percent – is generally applied only at the consumer level.

Some of the exemptions discussed in this report – most notably the contractor-subcontractor and federal cost-plus contractor exemptions – attempt to eliminate tax pyramiding by exempting certain business-to-business transactions from GET.

For 2019, the most current tax year assessed in this report, Hawai'i GET rates were:

- 0.15 percent on commissions from insurance sales;
- 0.5 percent primarily on revenue received by manufacturers and wholesalers, as defined by statute; and
- 4 percent on revenue received from all other activities including, but not limited to, the retail sale of tangible personal property (goods) or services, construction contracting, renting or leasing real or personal property, business interest income, commissions (except insurance commissions), theaters and amusements.

## Exclusions and Exemptions

**POLICYMAKERS USE** tax preferences to promote various economic and social goals. Such provisions may allow money that would otherwise be spent on taxes to remain in the hands of taxpayers. For example, taxpayers who own or operate businesses may use those tax savings to create jobs. Other preferences may provide economic support to specific segments of society.

### EXCLUSIONS

**Exclusions remove revenues from certain activities that were never intended to be part of a broadly defined tax base. Excluded amounts generally are not included in a taxpayer's reported revenues and are therefore not taxed.**


Example: The exclusion for gross receipts from sales of securities excludes such revenue from GET. This revenue does not have to be reported. However, in some instances capital gains from securities sales are still subject to Hawai'i income tax.

### EXEMPTIONS

**Exemptions refer to receipts from taxable activities or goods that, for policy purposes, are not subject to tax collection.**

Example: Contractors can deduct payments made to subcontractors from their gross revenue and avoid GET liability on those amounts. The exemption for amounts paid by contractors to subcontractors shifts payment of GET at the 4 percent retail rate on those amounts to the subcontractor, effectively eliminating the pyramiding of GET. The Legislature hoped that the reduced taxes paid by general contractors would lower the cost of housing.

**EXEMPTIONS COME AT A COST.** Allowing certain taxpayers to reduce the amount of gross revenues that are subject to GET reduces the amount of tax revenues that might otherwise be available for the State to spend. While direct spending programs are subject to review through the budgetary process, monies the State does not see can be more challenging to evaluate. Identifying whether the benefits of tax exemptions outweigh their costs can be a complex endeavor, but such reviews can provide important information to legislators about the effectiveness of a tax preference and monies that may be available for other state priorities.

# How We Got GET
## General Excise Tax in Hawai'i

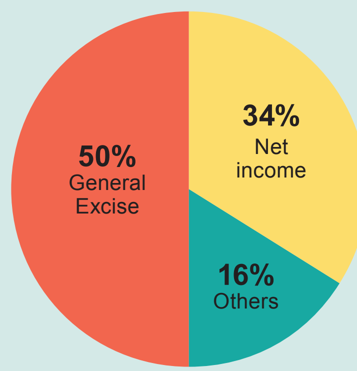
**HAWAI'I'S GET,** like most sales taxes across the country, is a product of the Great Depression. While the Islands did not experience the level of unemployment and economic distress experienced by industrialized areas of the United States, falling land values during the early 1930s led to a drop in real and personal property tax revenue, which were then the mainstays of the Hawai'i tax structure. In response, the 1932 Territorial Legislature cut real property tax rates and repealed the levy on personal property. To make up for the lost revenue, the Legislature adopted a business excise tax, which taxed the operating costs of each entity doing business in Hawai'i. In 1935, the Legislature replaced the business excise tax with GET, which taxed the gross proceeds of sales of goods and services in Hawai'i.

Containing elements of both business and consumption taxation, GET was designed to redistribute the tax burden to different industries and their consumers.[2] Estimates prepared for the 1935 House Finance Committee predicted that the sugar, ranching, and diversified agriculture industries would receive tax relief while the retail industry would experience the greatest tax increase. While the adoption could be viewed as a concession to some of Hawai'i's oldest and largest businesses, this change in tax policy may have been prophetic, as the Islands' economy underwent fundamental changes.

Even by 1939, the retailing industry was accounting for the Territory's largest "taxable value," today referred to as the "tax base," at $123.72 million, or 33 percent of the total $376.71 million tax base. At $41.60 million, sugar comprised 11 percent of the tax base, with pineapple close behind at $35.44 million, or 9 percent of the tax base. Meanwhile, the tax base for service industry businesses was just $17 million, or 4.5 percent of the total. By Statehood in 1959, while all industries rose with the favorable economic tides, the gap between business and consumption tax bases grew wider. Retailing's tax base ballooned to $707.53 million (35 percent of the total tax base) while services saw even greater growth at $160.49 million (8 percent of the total). Meanwhile, sugar and pineapple had tax bases of $93.42 million and $98.43 million respectively, with each comprising about 5 percent of the tax base.

Today, the retailing and service industries are still the breadwinners for the State when it comes to GET. For 2018, DoTax reported that retailing had a tax base of $36.36 billion, or 33 percent of the total tax base, with services at $16.66 billion, or 15 percent of the tax base.

**Exhibit 1.1**
**State of Hawai'i General and Other Governmental Funds Tax Revenues by Type, FY2018**




Note: "Others" includes taxes such as the Transient Accommodations Tax, tobacco and liquor tax, and liquid fuel tax.

Source: FY2018 Comprehensive Annual Financial Report of the State of Hawai'i.

In FY2018, the State realized a total of $7.19 billion in tax revenue. Most of that revenue came from two taxes: GET and the individual income tax. GET is Hawai'i's largest tax revenue source, accounting for $3.55 billion, or 50 percent of total tax revenue. The net income tax collections, which are comprised of both individual and corporate income tax revenues, represent Hawai'i's second-largest tax revenue source and accounted for $2.46 billion. The Transient Accommodations Tax, or hotel room tax, is the State's third-largest revenue source, accounting for $304.52 million.

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[2] Hawai'i's General Excise Tax, Report No. 2, 1963, Legislative Reference Bureau, State of Hawai'i, p. 8.

### Use Tax (Chapter 238, HRS)

According to DoTax, Hawai‘i imposes an excise tax on the use in the State of property and services that are purchased from persons or entities outside Hawai‘i – who are not required to pay GET – and imported to the State. Use Tax is assessed to the person or entity importing the goods or services at rates that vary based on whether the imported goods or services are resold or used by the importer. Similar to GET, Use Tax has a wholesale rate of 0.5 percent of the value of goods and services imported to Hawai‘i for resale and a retail rate of 4 percent of the value of goods and services imported for the importers’ own use or consumption.

Since January 2007, the City and County of Honolulu has also imposed a 0.5 percent GET and Use Tax surcharge. Hawai‘i and Kaua‘i counties have adopted 0.25 percent and 0.5 percent surcharges in their respective counties, both of which took effect in 2019. There is no surcharge collected on activity exempted from GET or Use Tax.

## Analysis of Reviewed Tax Provisions

This report reviews a total of 13 tax provisions, which include 6 GET and Use Tax exemptions and 7 GET exclusions. DoTax tracks the cost of 9 of these tax provisions, however, for 2 provisions claimed by fewer than 10 taxpayers, reporting was limited. DoTax policy prevents the public reporting of information about tax provisions claimed by fewer than 10 taxpayers to protect confidential taxpayer information.

## Assessment Challenges: Lack of Data on Cost, Causation

Many challenges hindered our ability to report information and analyze the exemptions and exclusions as required under Section 23-71, HRS, most significantly, the lack of available data. Prior to 2017, DoTax did not systematically track GET and Use Tax exemptions, meaning there is little, if any, data about the number of taxpayers that claimed each exemption or the amounts they claimed. While development of the department’s Tax Modernization System project has allowed for better data collection, DoTax currently does not track additional specific information we need to more meaningfully assess the exemptions from GET and Use Tax.

For some provisions, the lack of historical data precluded us from determining “the amount of tax expenditure for the exemption, exclusion, or credit for each of the previous three calendar years,” as required by Section 23-71, HRS.

The absence of historical data also hindered our ability to estimate the amounts of tax expenditures for the current and next two calendar years. Without that data and the expertise to forecast economic trends, we determined any projection on the future cost of exemptions and exclusions would be too speculative and unreliable to be included in this report.  As the data continues to be tracked, we will reach a point in the future where meaningful projections can be made; because DoTax only recently began collecting data, that point is likely to be some years away.

We were further challenged to determine the purpose of some exemptions and exclusions.  As noted throughout this report, the legislative acts that created the exemptions and exclusions often lacked a clear statement of the purpose of the tax preference.  Where available, we used other

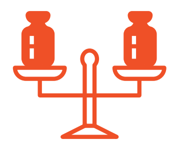
## Tax Equity and Efficiency: Finding the Balance

**WE ARE REQUIRED** to assess tax equity and efficiency as part of our review.  However, the Hawai'i Revised Statutes do not define these terms.  Accordingly, our evaluations were guided by criteria developed by the U.S. Joint Committee on Taxation and from the U.S. Government Accountability Office, as detailed in the Association of International Certified Professional Accountants (AICPA) publication *Guiding Principles of Good Tax Policy: A framework for evaluating tax proposals*.  The Joint Committee on Taxation is a nonpartisan committee of the United States Congress that, among other things, investigates the administration, operation, and effects of taxes.

Tax *equity* is the principle of taxing similar taxpayers similarly. The concept of horizontal equity provides that two taxpayers with equal abilities to pay should pay the same amount of tax.  In contrast, vertical equity provides that a person with the greater ability to pay should pay more tax.

Tax *efficiency* is the principle that a tax system should not unduly impede or reduce the productive capacity of the economy.  All taxes have the capacity to change how a taxpayer may behave; for example, a GET exemption for local dairy farmers could stimulate development of the local dairy industry by lowering the industry's costs, thereby creating a competitive advantage.  Under the concept of efficiency, a tax system should avoid hindering economic goals, such as economic growth, capital formation, and competitiveness with other jurisdictions.  A separate, but related, concept states that administrative and compliance costs should be kept low to foster effective tax administration.  For purposes of this report, we primarily discuss economic efficiency rather than administrative efficiency, but do mention some administrative issues we deemed significant.

Sometimes a tax exemption, designed to increase economic activity in a certain industry or geographic area, will reduce tax equity by providing favorable treatment to these activities. Therefore, lawmakers must carefully balance both principles to optimize tax policy.



The concept of **horizontal equity** provides that two taxpayers with equal abilities to pay should pay the same amount of tax.

In contrast, **vertical equity** provides that a person with the greater ability to pay should pay more tax.

## Tax Expenditures: At What "Cost"?

**AS DOTAX EXPLAINS** in its 2018 *Hawai'i General Excise and Use Tax Exemptions* report: "[t]ax expenditures are the implied revenue cost of the deviation from a uniform application of the excise and use tax." Determining the true "cost" of a given tax exemption or exclusion is difficult. And, at times, our estimates of tax expenditure amounts differ from the amounts reported in DoTax's annual GET and Use Tax expenditure reports. As we explain, this is largely because DoTax often applies a lower, "ideal" tax rate to the amounts claimed, not the actual rates reported by claimants on GET/Use Tax returns.

The 2018 DoTax report explains they calculate the amount of a given tax expenditure by applying a tax rate that would be applied under an "ideal" tax system – oftentimes this "ideal" tax rate is the much lower wholesale rate of 0.5 percent rather than the 4 percent retail rate applicable under current law[3] :

> ***[T]ax expenditures are valued at the tax rate they should be taxed at to achieve the assumed ideal tax system. These assumptions may not agree with the actual tax rates that would apply if an exemption were repealed.*** *For example, each exemption categorized as tax expenditure at the wholesale rate may not qualify for the 0.5% rate under the wholesale rules of Section 237-4, HRS. (Emphasis added.)*

We take a different approach in arriving at some of the estimated amounts of tax expenditures in our report. While DoTax applies the "wholesale" rate (0.5 percent) to the entire amount even where the exemption "may not qualify for the 0.5% rate" under the Hawai'i tax code's wholesale rules, we use data provided to us by DoTax from the GET and Use Tax returns and apply the tax rate claimed by actual taxpayers in accordance with applicable tax laws; this at times results in the application of the 4 percent retail rate. In these cases, this has yielded a "tax expenditure" amount much greater than amounts calculated by DoTax in its *Hawai'i General Excise and Use Tax Exemptions* reports. There are also some differences in the total amounts claimed for the exemptions; these differences are due to updated DoTax data used in our report.

Additionally, DoTax does not consider certain provisions to result in "tax expenditures" and, therefore, does not include them in their report. Some provisions (for example, the exclusion for gross receipts from sales of securities) cover revenue which DoTax asserts was never meant to be included in Hawai'i's tax base, and therefore, DoTax does not consider to be associated with "forgone" tax revenue.

DoTax acknowledges that their approach to calculating tax expenditure amounts is based on debatable assumptions:

> *It is important to understand that the decision to label GET exemptions as tax expenditures at the wholesale or retail rate or not as tax expenditures at all is based on economic parameters and assumptions that are subject to debate. Thus, if DOTAX's assumptions change, then the distribution of exemptions among the categories may change.*

Finally, as DoTax's 2018 *Hawai'i General Excise and Use Tax Exemptions* report notes, tax expenditures do not equate to the true amount of revenue realized if the exemption were to be repealed:

> *In presenting data on tax exemptions, it is also crucial that a clear distinction be made between tax expenditures and revenue estimates. The data presented in this report provides only the amounts of each exemption claimed and should not be relied on as an estimate of the amount of revenue that may be realized by repealing an exemption. An estimate would have to account for the substitution and behavioral effects of repealing an exemption.*

Although we agree with this statement, we believe that the better measure of a "tax expenditure" applies the *actual* tax rates required by current law, not an "*ideal*" tax rate that does not exist in fact.

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[3] Under DoTax's methodology pursuant to 1 Rousslang, Donald (2013), "Tax Expenditures in Paradise," State Tax Notes, May 13, pp. 549-558, an ideal tax system would exempt all "business-to-business" sales from GET.

sources, such as committee reports and other legislative history, to infer the purpose of an exemption or exclusion; however, even then, we were unable to assess whether a particular tax provision is meeting its purpose since none of the provisions include specific benchmarks against which the provisions are to be measured.

An analysis of economic or employment benefits compared against forgone tax revenue was hampered by a variety of other factors. Businesses that claimed these exclusions and exemptions were not required to provide data beyond the amount claimed to DoTax. Additionally, we were unable to share taxpayer names and other confidential filing data with the Department of Labor and Industrial Relations to independently identify and verify employment and payroll data for taxpayers claiming exemptions.

Taxpayers do not report to DoTax data on jobs, wages, or certain other economic activities that may have been generated because of a tax provision. To obtain such information, at our request, DoTax sent surveys to claimants of the three most costly of the reviewed economic development exemptions. These provisions provided incentives for construction contracting, aircraft and aircraft engine leasing, and aircraft servicing and aircraft maintenance facility construction. Overall, we received 56 responses to surveys sent to 275 of the 2,225 taxpayers claiming the exemption on gross income of contractors from subcontractors. We surveyed all taxpayers claiming the aircraft and aircraft engine rental and leasing exemption under Sections 237-24.3(11) and 238-1, paragraph (6), and all 20 taxpayers claiming the aircraft servicing and maintenance facility construction exemption under Sections 237-24.9 and 238-1, paragraph (8), however, we received just two responses from taxpayers claiming the exemption for aircraft servicing and maintenance facility construction, and none from taxpayers claiming the aircraft and aircraft engine rental and leasing exemption.

Further, our analysis could not account for a variety of unintended effects. For example, some businesses that claimed an exemption aimed at generating economic activity may have received tax preferences for jobs that would have been created irrespective of the tax preference, while other jobs may have been filled by non-residents. We were likewise unable to assess the disadvantages faced by businesses and industries that were not eligible for the tax preference. As a result of these challenges, we could not make a causal connection between any potential Hawai‘i employment or economic gains and the use of these exemptions.

Finally, as required by statute, we conducted an analysis of the impact of tax provisions on “low-income residents” using the formula provided in the statute. However, we question whether the calculations represent the value that repeal of a particular exemption or exclusion would have for low-income residents. Although money generated from repealing a particular exemption or exclusion likely will increase tax revenues, the impact of the additional funds will not automatically accrue a benefit to low-income residents in particular, but to all residents. Further discussion, as well as our calculations, can be found in Appendix B.

In order to facilitate future reviews, we make the following recommendations:

1. For new tax credits, exemptions, and exclusions, the Legislature should include (1) a clear statement of the purpose of the tax provision and (2) objective criteria to determine whether the tax preference is meeting that purpose. As part of our reviews, we are to determine, among other things, whether the tax provision "has achieved and continues to achieve the purpose for which it was engaged by the Legislature." Without a statement of legislative intent for each tax provision as well as specific metrics to assess whether the provision is meeting the intended purpose, we will not be able to report important information for many provisions and likely cannot assess whether the benefit outweighs the cost of the preference.

   A similar approach has been taken by the State of Washington, whose Legislature has noted this type of additional detail, such as demographics to be used to measure effectiveness, is important to facilitating future reviews of its tax preferences.

2. For the same reasons, the Legislature should amend current tax credits, exemptions, and exclusions to include (1) a clear statement of the purpose of the tax provision and (2) objective criteria to determine whether the tax preference is meeting that purpose.

3. Taxpayers claiming an exemption from GET or Use Tax should be required to provide specific data as part of their filing to demonstrate how the tax preference supports business growth. For example, businesses could be required to attest to and provide documentation on the number of jobs, the total amount in wages, or other metrics directly related to a preference that is intended to provide an economic or employment benefit to the State. Such information would yield important data we need to provide more meaningful information about the actual benefits associated with a particular tax preference that the Legislature can consider as it evaluates whether to retain, modify, or repeal the provision.

# Exemption for Amounts Paid By Contractors to Subcontractors (Section 237-13(3)(B), HRS)

**Exemption at a Glance (2018)**

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| $4.14 billion | 2,272 | $20.68 million | $43.12 | Unable to determine |

## What does this exemption do?

The exemption for amounts paid by contractors to subcontractors allows a "prime" contractor, i.e., a contractor that works directly with an owner, developer, or another contractor, to deduct amounts paid to a subcontractor from gross revenues subject to GET. The exemption transfers the responsibility for GET on those amounts to the subcontractor – at the retail rate of 4 percent, instead of the 0.5 percent wholesale rate. Contractors claiming the exemption must list the name and GET license number of the subcontractor on their GET returns. Subcontractors can also exempt amounts paid to their sub-subcontractors from their revenues subject to GET under this exemption. Taxpayers claiming these exemptions must file DoTax's Schedule GE form and report the corresponding amounts as an exemption on their GET/Use Tax returns.

## How does this exemption work?

A homeowner pays a general contractor $100,000 for a kitchen remodel project and the contractor, in turn, pays $20,000 of that amount to a plumbing subcontractor. The general contractor can exempt the amount paid to the plumbing subcontractor, i.e., $20,000, from the revenue subject to GET. Instead of paying GET on the gross receipts of $100,000, the general contractor pays the 4 percent GET rate on $80,000, and the plumbing subcontractor pays the 4 percent GET rate on $20,000, the amount it was paid. The total GET paid by the general contractor and plumbing subcontractor is $4,000 (4 percent on $80,000 plus 4 percent on $20,000).

Without the exemption, the general contractor would be subject to GET at 4 percent on its gross revenues of $100,000, and the plumbing subcontractor would pay the GET on its gross revenues of $20,000 at the wholesale rate of 0.5 percent. The total GET paid by the general contractor and plumbing

### History of the Exemption

**1935**
The Territorial Legislature enacted a general excise tax that allows contractors to deduct amounts paid to other contractors from their gross income subject to the tax. (See Sidebar – "How We Got GET" on page 5.)

**1970**
The exemption was amended to allow contractors to exempt amounts paid to specialty contractors in addition to amounts paid to other contractors.

**2011**
GET and Use Tax exemptions, including the contractor-subcontractor exemption, were temporarily suspended for FY2012 and FY2013.

subcontractor would be $4,100 (4 percent on $100,000 and 0.5 percent on $20,000).

### What is the purpose of this exemption?

The Hawai‘i Revised Statutes do not state a purpose for this tax expenditure. However, a conference committee report from 1970 notes the committee earlier "hoped" that effects from the exemption would "appear as a reduction in the cost of housing." Although we were unable to locate any other statement in the legislative history about the exemption's purpose, we surmise another purpose of the exemption is to reduce tax pyramiding, i.e., taxes on taxes, by requiring only the entity actually providing the construction-related services – the subcontractor – to be subject to GET on the revenues received for those services.

### Is this exemption meeting its purpose?

There is insufficient data for us to determine whether this exemption has reduced the cost of housing. However, the exemption does eliminate tax pyramiding by allowing a contractor to shift its 4 percent retail GET liability to its subcontractor, eliminating the 0.5 percent wholesale GET that the subcontractor would otherwise pay.

### What were the number of claimants, total amount claimed, and tax expenditures for this exemption from 2016-2018?

In its 2018 *Hawai‘i General Excise & Use Tax Exemptions* report, DoTax calculates the amount of tax expenditures relating to the exemption for amounts paid by contractors to subcontractors using the GET wholesale rate of 0.5 percent. DoTax presumes that all the forgone tax revenue would have been at the GET wholesale rate of 0.5 percent.

We question DoTax's presumption. Without the exemption, it seems unlikely that all subcontractors would be able to apply the GET wholesale rate to their revenues; some subcontractors' revenue likely would be subject to the retail rate of 4 percent. For example, architects, engineers, and land surveyors are included in the definition of "contractor," which under the exemption allows a contractor to exempt amounts paid to those professionals. However, architects, engineers, and land surveyors may not be "wholesalers," as defined in the tax statute, and therefore, their revenues would be subject to the GET retail rate of 4 percent, not the 0.5 percent wholesale rate.

We recognize that the number of subcontractors whose revenues, without the exemption, would be subject to the GET retail rate of 4 percent is relatively small. Because we are not able to quantify this relatively small amount, we conclude that it is reasonable to apply the 0.5 percent retail rate to arrive at an estimate of the tax expenditure associated with this

| Year | Number of Claimants | Amount Claimed | Tax Expenditure | DoTax Tax Expenditure |
|---|---|---|---|---|
| 2018 | 2,272 | $4.14 billion | $20.68 million | $18.59 million*** |
| 2017 | 2,276 | $4.04 billion | $20.18 million | $17.99 million** |
| 2016 | 2,209 | $3.89 billion | $19.46 million | N/A* |

Source: Department of Taxation report based on GET filings as of November 1, 2019.

* DoTax did not publish data on tax expenditures in its 2016 report.
** DoTax data was based on returns for the filing period January 1 to December 31, 2017.
*** DoTax data was based on returns for the filing period as of November 5, 2019.

exemption. Therefore, we apply the 0.5 percent rate to the total amounts claimed as reflected in the actual GET and Use Tax filing data provided by DoTax as of November 1, 2019.

### Is the exemption necessary to promote or preserve tax equity or efficiency?

This exemption provides a tax preference to a certain sector of the economy; by definition, it does not promote tax equity. However, the exemption promotes tax efficiency by eliminating the taxing of the same revenue at multiple levels of a construction project.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exemption?

We cannot determine the economic or employment benefit, if any, that resulted from the exemption or whether those benefits offset the cost. We were unable to obtain key data, including construction project type, payroll and wage information for contractors that claimed the exemption, or data on how the exemption impacted construction costs and jobs. And, there is no means for us to assess whether contractors used realized GET savings to actually lower construction costs, add jobs, increase profits, or for other purposes. Metrics for evaluating effectiveness and access to data on employment could assist in determining whether the provision has resulted in an economic or employment benefit and whether the benefit outweighs the cost.

We surveyed 275 of the 2,272 contractors that claimed the exemption in 2018, including the 25 contractors with the largest exemption claims. Of the 56 responses received, 50 respondents stated the exemption was somewhat or very important to their ability to continue doing business in Hawai‘i and to retain existing jobs; 44 respondents stated the exemption was somewhat or very important to creating jobs;

35 respondents stated the exemption was somewhat or very important in reducing housing costs; and 49 respondents stated the exemption was somewhat or very important for increasing profitability. At least one response seemed overstated, with that respondent claiming 500 construction jobs were retained or created by the exemption. We note this self-reported information is unverified.

**$72,799**

Average tax savings per contractor claiming the exemption.

In 2018, contractors exempted over $4.14 *billion* in revenue from GET under this exemption, saving a total of $165.4 million in GET or an average of $72,799 per contractor claiming the exemption. However, subcontractors may have passed some or all of their GET costs to contractors.

If the exemption is repealed, DoTax estimates that contractors would pay the retail GET rate on gross receipts (including the amount paid to subcontractors) and subcontractors would pay the wholesale GET rate on revenue received from contractors. Based on this assessment, if, for example, subcontractors in 2018 had paid GET at the wholesale rate of 0.5 percent on the entire $4.14 billion that contractors exempted from their revenues, the State would have received approximately $20.7 million in additional tax revenue. This value may not represent amounts the State will recoup if the exemption is repealed, since taxpayers may avail themselves of other exemptions or otherwise modify their behavior to avoid paying the tax.

According to the American Subcontractors Association of Hawai‘i, during the two-year period (fiscal years 2012 and 2013) that the exemption was suspended, contractors purchased materials directly from material suppliers instead of having their subcontractors purchase those supplies. DoTax did not estimate the amount of additional tax revenue that the State realized from the exemption's suspension.

### Should the exemption be retained without modification, amended, or repealed?

There is insufficient data to determine whether this exemption should be retained, amended, or repealed.

### Issues of concern

*DoTax has not enforced filing requirements or confirmed subcontractor GET payments at the 4 percent rate.*

Contractors that exempt amounts paid to their subcontractors from their gross revenues subject to GET must include the names and GET license numbers of the subcontractors on their GET return. We infer that the purpose of requiring contractors to report the name and general excise tax license number of their subcontractors is so DoTax can confirm and enforce payment by the subcontractors of GET at 4 percent, not 0.5 percent, on those amounts exempted by the contractors.

We noted during our review that DoTax has not enforced the requirement that contractors claiming the exemption provide the name and GET license number of their subcontractors that are responsible for payment of GET at the retail rate of 4 percent on the deducted amounts. We found this information was sometimes missing on GET returns where contractors claimed the exemption. DoTax also told us that it has not verified or otherwise enforced the requirement that the subcontractors pay the GET at 4 percent on those revenues deducted by the contractors. Without reasonable assurance that subcontractors are paying the appropriate amount of GET, any estimate of the "cost" of the exemption, i.e., the amount of GET the State is forgoing, is speculative and, more importantly, may be significantly more than intended by the Legislature. For example, we calculate the cost of the exemption to be about $21 million in 2018 based on our assumption that subcontractors paid GET on the amounts deducted by contractors at the 4 percent retail rate, as the law requires. However, hypothetically speaking, if subcontractors paid GET on the amounts deducted by contractors at 0.5 percent wholesale rate, which may be the applicable rate for revenue that is not deducted by contractors, the cost of the exemption is over $165 million, a difference of about $144 million. Without verification, even based on a mathematical sample, there is no means to know the actual cost of the exemption.

However, even if contractors identified their subcontractors as required, we question whether that information is sufficient to allow DoTax to verify and enforce payment by those subcontractors at the appropriate GET rate on the deducted amounts in every instance. We observed that, currently, contractors report on their GET returns the total revenue they are deducting for purposes of GET under this exemption but do not include other data, such as the name of the project or tax map key number of the property. Without project-specific data, we question whether DoTax has sufficient information to ensure payment of GET at 4 percent on the amount of gross revenues exempted by the contractor. For example, a contractor deducts $100,000 of revenue that the contractor pays to its subcontractor; the subcontractor in turn deducts $50,000 that it pays to a sub-subcontractor. That sub-subcontractor may report revenue from other contractors who do not claim the exemption as well as for work performed directly with an owner. Without project-specific information, DoTax may not be able to trace the revenue exempted by the contractor and subsequently by the subcontractor.

During our review, we also noted instances when a subcontractor that was liable for revenue exempted by a contractor subsequently used the exemption to exempt revenue paid to yet another subcontractor. For example, we reviewed the GET filings of businesses with the three largest claims for this exemption to assess whether any of their top three subcontractors also claimed the subcontractor exemption. We found that seven out of nine of these subcontractors also claimed this exemption.

# Exemptions for Aircraft and Aircraft Engine Rental or Leasing (Sections 237-24.3(11) and 238-1, paragraph (6) of the definition of "use," HRS)

**Exemptions at a Glance (2018)**

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| $49.80 million | 13 | $1.97 million | $4.11 | Unable to determine |

### What do these exemptions do?

The exemptions for aircraft and aircraft engine rental or leasing exempt revenue from the lease or rental of aircraft and the lease or rental of aircraft engines used for interstate[4] transportation of passengers and goods from GET. Similarly, amounts paid to an out-of-state vendor for lease or rental of aircraft or aircraft engines are not subject to Use Tax. Taxpayers claiming these exemptions must file DoTax's Schedule GE form and report the corresponding amounts as an exemption on their GET/Use Tax returns.

### How do these exemptions work?

Kāneʻohe Capital is a Hawaiʻi corporation in the business of leasing airplanes. Kokua Airlines lease airplanes from Kāneʻohe Capitol for $1 million a year. Without the exemption, Kāneʻohe Capital would be subject to GET at 4 percent (or $40,000 for each year of the lease) on the lease revenue.

Kokua Airlines also leases airplanes for its Hawaiʻi interisland service from a California business for $1 million a year. The value of the airplane that Kokua Airlines imports to Hawaiʻi for its interisland service – in this case the lease payments – would be subject to Use Tax at a rate comparable to the GET retail rate of 4 percent (or $40,000 per each year of the lease). However, because the law excludes the leasing or renting airplanes (and airplane engines) from the law's definition of "use," airlines and other businesses that provide interisland air transportation and lease or rent aircraft or aircraft engines from non-Hawaiʻi entities are exempt from paying Use Tax on those transactions.

### History of the Exemption

**1965**
The Legislature amended the definition of "use" to exclude the leasing or renting of any aircraft or the keeping of any aircraft solely for leasing or renting to lessees or renters using such aircraft as a public utility.

**2001**
The Legislature established a GET exemption for amounts received for the rental or leasing of aircraft or aircraft engines used by the lessees or renters for interstate air transportation of passengers and goods. It also exempted the acquisition or importation of any such aircraft or aircraft engines by any lessee or renter engaged in interstate air transportation.

**2011**
GET and Use Tax exemptions, including the aircraft and aircraft engine rental or leasing exemptions, were temporarily suspended for FY2012 and FY2013.

[4] As explained below in "Issues of Concern," the statute uses the word "*interstate*;" this may be inconsistent with what we infer to be the purpose of this exemption as described in committee reports, to support "*interisland*" air carriers.

### What is the purpose of these exemptions?

The Hawai‘i Revised Statutes do not directly state a purpose for these exemptions. However, Act 210, SLH 2001, which established the GET exemption and clarified the Use Tax exemption, referenced the importance of Hawai‘i's interisland air carriers. Committee reports also indicate that the intended beneficiaries are interisland, or intrastate, air carriers. We therefore infer the general purpose of these exemptions is to support interisland air carriers. However, without specific statutory language or legislative history, we are unable to determine whether the exemptions are also intended for other purposes.

### Are these exemptions meeting their purpose?

We are unable to determine whether the exemptions are meeting their purpose. We cannot make a causal connection between use of these exemptions and support for interisland air carriers, and neither the statutory provisions nor legislative history provide goals or other measures which could help us define whether the exemptions are meeting their purpose.

### What were the number of claimants, total amount claimed, and tax expenditures for these exemptions from 2016-2018?

DoTax does not track the GET and Use Tax exemptions separately, so the figures below represent the combined claims under both the GET and Use Tax exemptions.

DoTax calculated the amount of the tax expenditure associated with these exemptions by multiplying the total amount claimed by the wholesale rate (0.5 percent), considering these to be business-to-business transactions. We calculate the tax expenditure for these exemptions to be the value of the claim multiplied by the associated tax rate that taxpayers claiming the exemptions actually reported on their GET and Use Tax returns (see sidebar “At What ‘Cost’?” at p. 8). Based on our review of data compiled by DoTax from the returns filed by the taxpayers claiming the exemptions, most deductions were made at the retail rate (4 percent), not the wholesale rate (0.5 percent). Using this methodology, we estimate the tax expenditures for 2016, 2017, and 2018 for this exemption as follows:

### Are the exemptions necessary to promote or preserve tax equity or efficiency?

These exemptions provide a tax preference to a certain sector of the economy. By definition, they do not promote tax equity.

| Year | Number of Claimants | Amount Claimed | Tax Expenditure | DoTax Tax Expenditure |
|---|---|---|---|---|
| 2018 | 13 | $49.80 million | $1.97 million | $246,000*** |
| 2017 | 14 | $63.64 million | $2.54 million | $225,000** |
| 2016 | *Confidential** | *Confidential** | *Confidential** | *Confidential** |

Source: Source: Department of Taxation report based on GET filings as of November 1, 2019.

* According to DoTax, specific claimant data for 2016 could not be publicly disclosed for taxpayer confidentiality reasons as there were fewer than 10 claimants.
** DoTax data was based on returns for the filing period January 1 to December 31, 2017.
*** DoTax data was based on returns for the filing period as of November 5, 2019.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exemptions?

We could not determine the economic or employment benefit, if any, that resulted from the exemptions. We do not know whether interisland passenger or cargo airline operators benefited from the tax preference conferred on leasing companies. And, because the exemptions are not tracked separately, we cannot determine which taxpayers are claiming the exemption from Use Tax and whether those carriers passed on those savings to customers. Therefore, our cost versus benefit review of these exemptions was hampered by an inability to determine whether the exemptions reduced airline operator costs, and ultimately the cost to consumers.

### Should the exemptions be retained without modification, amended, or repealed?

There is insufficient data to determine whether this exemption should be retained, amended, or repealed.

### Issues of Concern

We note that the use of the term "*interstate*" air transportation in the statutes differs from the language used in the purpose expressed in the legislative history to benefit "*interisland*" carriers. Both statutory provisions expressly apply to leasing or rental in connection with "interstate air transportation," as defined in 40 United States Code section 40102. That section defines the term as, among other things, "transportation of passengers or property…between…a State, territory, or possession of the United States and…another State, territory, or possession of the United States[.]" The plain wording of the exemptions appears to allow any air carrier transporting passengers or cargo to and from Hawai‘i to other states – not just those carriers providing interisland service – to deduct amounts spent to lease or rent aircraft or aircraft engines from entities outside of Hawai‘i from Use Tax. That application of the exemption seems inconsistent with the purpose, which the legislative history noted is to support the interisland airline industry.

We also note that DoTax does not require taxpayers claiming the exemption to separately report amounts they are deducting from gross revenues subject to GET separately from amounts exempted from Use Tax. For that reason, we can only report the consolidated GET and Use Tax figures for the number of claimants and the total amounts of those claims, which limits transparency about the tax expenditures and prevents us from being able to assess the exemptions separately.

## Exemptions for Aircraft Servicing and Maintenance Facility Construction (Sections 237-24.9 and 238-1, paragraph (8) of the definition of “use,” HRS)

**Exemptions at a Glance (2018)**

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| $38.39 million | 17 | $1.53 million | $3.20 | Unable to determine |

### What do these exemptions do?

The exemption for aircraft servicing exempts income from the maintenance and servicing of aircraft from GET. The exemption for maintenance facility construction exempts revenue paid to contractors, subcontractors, and suppliers for the construction of aircraft maintenance facilities of 30,000 square feet or more from GET. Taxpayers claiming these exemptions must file DoTax’s Schedule GE form and report the corresponding amounts as an exemption on their GET/Use Tax returns.

The Use Tax exemption for aircraft servicing and maintenance facility construction exempts amounts paid for materials, parts, or tools used for aircraft service and maintenance as defined by statute to a non-Hawai‘i seller, as well as amounts paid for construction of an aircraft service and maintenance facility.

### How do these exemptions work?

Kokua Airlines pays Kāne‘ohe Air Services Company $100,000 for qualifying maintenance and servicing of its planes when Kokua Airlines’ mechanics are too busy working on other company aircraft. Mahalo Air Services’ revenue from that work ($100,000) is not subject to GET.

Kokua Airlines also employs its own mechanics, who collectively are paid $2 million, to maintain and service its aircraft. The exemption does not apply to Kokua Airlines’ costs and, therefore, does not allow Kokua Airlines to deduct any of the salaries or other benefits it pays its mechanics.

A contractor is hired by Kokua Airlines to build a 30,000 square foot aircraft maintenance facility for $300,000. The contractor does not pay

### History of the Exemptions

**1997**
The Legislature created a GET exemption that allows deductions for certain qualifying amounts paid to service and maintain aircraft, as well as to build an aircraft service and maintenance facility in Hawai‘i. It also amended the definition of “use” to exclude materials, parts, or tools imported for those activities.

**1998**
The Legislature amended the exemption to include construction of smaller servicing facilities, reducing the size requirements to 30,000 square feet, rather than 80,000 square feet.

**2011**
GET and Use Tax exemptions, including the aircraft servicing and maintenance facility construction exemptions, were temporarily suspended for FY2012 and FY2013.

GET on the $300,000. The contractor imports tools and material for this work from out-of-state, at a cost of $5,000; the amounts paid for these tools and materials are not subject to Use Tax.

### What is the purpose of these exemptions?

The Hawai'i Revised Statutes do not directly state a purpose for these tax exemptions. However, the legislative history for Act 107, SLH 1997, notes the purpose of the bill is to "encourage business opportunities in the [S]tate" by, among other things, exempting from GET amounts received from the servicing and maintenance of aircraft or from the construction of an aircraft service and maintenance facility in the State.

### Are these exemptions meeting their purpose?

There is insufficient data to determine whether the exemptions are meeting their purpose. These exemptions encourage business opportunities in aircraft servicing and maintenance and the construction of service and maintenance facilities by reducing taxes paid by businesses providing those services. However, we are unable to determine whether there were any increased business opportunities directly resulting from the exemptions.

### What were the number of claimants, total amount claimed, and tax expenditures for these exemptions from 2016-2018?

DoTax's methodology for calculating the tax expenditure for this exemption in its *2018 Hawai'i General Excise & Use Tax Exemptions* report is to multiply all claims against the 0.5 percent wholesale rate based on its belief that, in an "ideal" tax system, these are business-to-business transactions that should be taxed at the wholesale rate.

We calculate the tax expenditure for these exemptions to be the value of the claim multiplied by the associated tax rate that filers claiming the exemptions actually reported on their GET and Use Tax returns (see sidebar "At What 'Cost'?" at p. 8). Based on our review of taxpayer data, most deductions were made at the retail rate (4 percent), not the wholesale rate (0.5 percent). Using this methodology, we estimate the amount of the tax expenditures for 2016, 2017, and 2018 for this exemption as follows:

| Year | Number of Claimants | Amount Claimed | Tax Expenditure | DoTax Tax Expenditure |
|---|---|---|---|---|
| 2018 | 17 | $38.39 million | $1.53 million | $155,000*** |
| 2017 | 21 | $61.54 million | $2.46 million | $242,000** |
| 2016 | 17 | $102.13 million | $4.09 million | N/A* |

Source: Source: DoTAX report based on GET filings as of November 1, 2019.

Notes:
* DoTax did not publish data on tax expenditures in its 2016 report.
** DoTax data was based on returns for the filing period January 1 to December 31, 2017.
*** DoTax data was based on returns for the filing period as of November 5, 2019.

### Are the exemptions necessary to promote or preserve tax equity or efficiency?

These exemptions provide a tax preference to a certain sector of the economy. By definition, they do not promote tax equity.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exemptions?

We are unable to determine whether these exemptions have directly resulted in any economic or employment benefit.

According to the Department of Transportation (DOT), the Hawaiian Airlines maintenance facility was the only recent project likely to qualify for the exemption. However, both DOT and Hawaiian Airlines stated the exemption was not claimed in conjunction with the construction of the Hawaiian Airlines facility. The exemption does not require notice to the facility owner or any other entity be given by a contractor claiming the exemption. We found claims for the exemption in 2018 that appeared to be made by construction firms, rather than aircraft service companies. We did not verify that these companies were involved in the construction of the Hawaiian Airlines facility or another aircraft maintenance facility in Hawai‘i and have no basis to know whether the exemption was properly claimed.

We also sent surveys to all 20 taxpayers that claimed this exemption in 2018 but received just two responses. Although the survey responses are unverified, one respondent reported the exemption resulted in eight retained jobs and 12 created jobs with hourly wages ranging from $15 to $38.

Aloha Air Cargo said the exemption lessened the cost of the more than $15 million facility that it completed in 2015.

### Should the exemptions be retained without modification, amended, or repealed?

There is insufficient data to determine whether this exemption should be retained, amended, or repealed.

### Issues of Concern

DoTax does not require taxpayers claiming the exemption to separately report amounts they are deducting from gross revenues subject to GET and amounts deducted from the lease costs paid to businesses outside of the State that would otherwise be subject to Use Tax.  For that reason, we are able to only report the consolidated number of filers claiming either the GET or Use Tax exemption and the total amounts of those claims.  In our opinion, it may be relevant for the Legislature and the public to know the specific number and amount of claims under both GET and Use Tax, respectively.

DoTax also does not require taxpayers to separately deduct revenue from service or maintenance of aircraft and that from building a maintenance facility.  We believe that segregating these amounts and tracking them separately would provide greater transparency about the tax expenditures and help legislators and the public better understand the use and effectiveness of these exemptions.

We further found that contractors, including subcontractors, can claim the exemption without notice to the maintenance facility owner or contractor.  Because DoTax does not require claimants to provide information identifying maintenance facility projects or clients, the department has no ability to assess the appropriateness of the claim without an audit.  Although Hawaiian Airlines' maintenance facility was completed in 2017, we found that for calendar year 2018, construction companies may have claimed exemptions relating to aircraft maintenance facility construction without DOT or Hawaiian Airlines' knowledge.

# Exemption for Amounts Received by Securities Exchanges or Exchange Members (Section 237-24.5, HRS)

## Exemption at a Glance (2018)

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| Cannot be reported | Fewer than 10 | Cannot be reported | Cannot be reported | No |

### What does this exemption do?

The exemption for amounts received by securities exchanges or exchange members exempts revenues received by securities exchanges for transaction fees charged to exchange members, membership dues, service fees, listing fees, and participation in the communication network consortium, from GET. The exemption also exempts revenue received by exchange members for execution of a securities or product transaction on an exchange, as well as proceeds from the sale of exchange memberships, from GET. Taxpayers claiming these exemptions must file DoTax's Schedule GE form and report the corresponding amounts as an exemption on their GET/Use Tax returns.

### What is the purpose of this exemption?

We found the purpose of the exemption is to attract security exchanges to the State. Although the Hawai'i Revised Statutes do not state the purpose for the tax exemption, committee reports reflect the Legislature's intent was to attract security exchanges to Hawai'i. The exemption was specifically expected to generate additional revenues for businesses and government, and promote the State as a financial center. The exemption only applies to transactions that occur on the floor of, or within a stock exchange, and not to transactions outside of a stock exchange. This effort to attract a stock exchange followed the closing of the Honolulu Stock Exchange in 1978.

### History of the Exemption

**1988**
Act 295, SLH 1988, established that GET shall not apply to a stock exchange's transaction fees, membership dues, listing fees, as well as amounts received by any stock exchange member when executing a securities transaction on the floor of a stock exchange.

**1989**
Act 118, SLH 1989, amended the exemption by, among other things, stating that it applied to an "exchange" rather than a "stock exchange," and by defining "exchange" as an exchange or board of trade as defined in U.S. Code and subject to regulation by the Securities and Exchange Commission, the Commodities Futures Trading Commission, or an organization subject to similar regulation under the laws of a jurisdiction outside the United States.

**2011**
GET and Use Tax exemptions, including the stock exchange exemption, were temporarily suspended for FY2012 and FY2013.

### Is this exemption meeting its purpose?

There have been no exchanges established in Hawai'i since passage of this exemption[5] and, according to DoTax, businesses may be misapplying the exemption.

Because there appears to be no economic activity in the arena targeted by this exemption, we conclude the exemption is not meeting its legislative purpose. However, based on the current claims to deduct revenue from exchange activity being made, we believe additional discussion with, and review by, DoTax is warranted to examine whether this exemption is being claimed properly.

### What were the number of claimants, total amount claimed, and tax expenditures for this exemption from 2016-2018?

According to DoTax, in 2016, 2017, and 2018, fewer than 10 entities claimed this exemption. To protect confidential taxpayer information, DoTax's policy does not allow disclosure of specific claimant data, including the total number of filers claiming the exemption or the total amount claimed, when there were fewer than 10 claimants for the year.

### Is the exemption necessary to promote or preserve tax equity or efficiency?

This exemption provides a tax preference to a certain sector of the economy. By definition, it does not promote tax equity.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exemption?

We were unable to identify any specific economic or employment benefit to the State, as no Hawai'i-based exchanges have been established since this exemption was enacted.

### Should the exemption be retained without modification, amended, or repealed?

To date, the purpose of this exemption – to attract a securities exchange to the State – has not been fulfilled. Accordingly, we recommend that the Legislature review this exemption and evaluate whether it should be retained.

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[5] The Department of Commerce and Consumer Affairs Commissioner of Securities, who is responsible for securities compliance and enforcement and investor education, is unaware of any stock exchange currently operating in Hawai'i. The Commissioner is also responsible for the registration of securities, broker-dealers and their sales agents, investment advisers and their representatives doing business in Hawai'i.

### Issues of Concern

Despite the fact that there is no stock or commodities exchange in Hawaiʻi, and apparently has not been one since this exemption was enacted, there are filers exempting revenue under this exemption. We are unable to report details because there were fewer than 10 claimants. We are also unable to determine any reason for the use of this exemption in the absence of a local exchange.

# Exclusion for Revenue from Sales of Commodity Futures (Section 237-3(b), HRS)

## Exclusion at a Glance (2018)

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| No data available | No data available | No data available | No data available | Yes |

### History of the Exclusion

**1989**
Act 118, SLH 1989, established that the words "gross income" and "gross proceeds of sales" shall not include contracts for the sale of a commodity for future delivery and other agreements, options, and rights that are traded on a board of trade designated by the Commodities Futures Trading Commission.

### What does this exclusion do?

The exclusion for revenue from sales of commodity futures excludes gross receipts from the sale of commodity futures from GET. Businesses are not required to report to DoTax the amount of revenue from the sale of commodity futures that they are excluding from GET.

### What is the purpose of this exclusion?

The law does not state the purpose for this specific exclusion. The legislative history indicates the purpose of Act 118, SLH 1989, as a whole, was to clarify that commodity futures sales are exempt from GET in an effort to foster such trading and attract exchange activity. The legislative history also mentions that the purpose of Act 118 was to clarify and redefine certain terms used to exempt from GET activities tied to securities exchanges. This particular exclusionary language does not appear to directly contribute to attracting an exchange, as it applies to *any* revenue from sales of commodity futures, not necessarily tied to a Hawai'i-based exchange. We found that this exclusion language was part of Act 118's addition of commodities future exchanges to the stock exchange exemption, to clarify that commodity futures sales are exempt from GET. Therefore, we conclude that this exclusion is an addition to the existing exclusion from GET for revenue from sales of securities, part of the effort to "clarify and redefine certain terms" in Act 118, SLH 1989.

### Is this exclusion meeting its purpose?

We conclude the exclusion is intended to treat revenues from commodities futures the same as revenues from the sale of securities under Section 237-3(b), HRS, in connection with the effort to attract Hawai'i-based exchange activity. We found the exclusion for sales of commodity futures is meeting its purpose, to the extent that this revenue is not intended to be part of the GET base.

### What were the number of claimants, total amount claimed, and tax expenditures for this exclusion from 2016-2018?

No specific data is available from DoTax on number of claimants, total amount claimed, or tax expenditure. DoTax does not require individuals or businesses to report gross proceeds from the sale of commodity futures to exempt revenues from GET. Additionally, DoTax does not consider that this exclusion results in a tax expenditure; as this revenue was never intended to be included in the GET base, there is no associated forgone tax revenue.

### Is the exclusion necessary to promote or preserve tax equity or efficiency?

This exclusion does promote tax efficiency. Capital gains from the sales of commodities futures contracts are in certain instances subject to income tax. Therefore, eliminating such receipts from GET prevents those investments from being subject to both income tax and GET.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exclusion?

We determined that the primary purpose is not for any specific economic or employment benefit.

### Should the exclusion be retained without modification, amended, or repealed?

Because the exclusion for sale of commodities futures excludes revenue that the Legislature never intended be subject to GET, we recommend the exclusion be retained.

# Exclusion for Gross Receipts from Sales of Securities, Exclusion for Fee Simple Sales of Improved or Unimproved Land, and Exclusion for Evidences of Indebtedness (Section 237-3(b), HRS)

## Exclusions at a Glance (2018)

### Securities

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| No data available | No data available | No data available | No data available | Yes |

### Real Estate

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| Incomplete data | Incomplete data | Incomplete data | Incomplete data | Yes |

### Evidences of Indebtedness

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| No data available | No data available | No data available | No data available | Yes |

## What do these exclusions do?

Revenue from the sale of securities, fee simple sales of improved or unimproved land, and evidences of indebtedness are excluded from the definitions of "gross income" and "gross proceeds of sale" and, therefore, not subject to GET. Generally, "gross income" and "gross proceeds of sale" comprise the GET base, meaning businesses pay GET based on those proceeds. In general, businesses are not required to report to DoTax the amount of revenue from the sale of securities and evidences of indebtedness that they are excluding from GET. However, under certain circumstances, contractors, developers, and dealers in real estate must file DoTax's Schedule GE form and report their revenues attributable to the sale of land in fee simple on their GET return to apply the land sales exclusion.

## What is the purpose of these exclusions?

Act 141, SLH 1935, and relevant legislative documents do not provide an express purpose for excluding revenue from sales of securities, evidences of indebtedness, and real property from GET. However, as explained in a 2013 article written by a DoTax tax research and planning officer, the GET law "is worded so broadly that without explicit exemptions, it would apply to many sales that are not properly part of a broad-based tax on income or consumption. For example, the GET contains exemptions for … sales of stocks and bonds, … sales of land in fee simple … items (that) have no proper place in the base of a sales or excise tax." Therefore, we infer the purpose of these exclusions is to remove this revenue from the GET base, as a matter of policy.

## Are these exclusions meeting their purpose?

We found the exclusions for gross receipts from sales of securities, fee simple sales of improved or unimproved land, and evidences of indebtedness are meeting their purposes, to the extent that the revenue is not intended to be part of the GET base.

## What were the number of claimants, total amount claimed, and tax expenditures for these exclusions from 2016-2018?

To exclude revenue from sales of securities or evidence of indebtedness from GET, DoTax does not require businesses to file a GET return, so data on number of claimants and amount claimed for those exclusions are not available. In order to deduct land sales from revenue subject to GET, under certain circumstances, contractors, developers, and others must report those amounts. Therefore, DoTax does track some data on the land sales exclusion.

### History of the Exclusions

**1935**
Act 141, SLH 1935, established a definition of "gross income" and "gross proceeds of sales" that excluded "gross receipts from the sale of bonds or other evidence of indebtedness or stocks or from the sale of real property." The definition was included in a Gross Income Tax Bill, which was described as a privilege tax – a tax for the privilege of doing business in the Territory of Hawai'i. (See Sidebar – "How We Got GET" on page 5.)

**1957**
Act 1, SLH 1957 (Special Session), amended the definition of real property to land in fee simple, improved or unimproved.

**1988**
Act 295, SLH 1988, amended language (including deletion of bracketed material) to "gross receipts from the sale of [bonds] securities as defined in section 485-1 or other evidence of indebtedness [or stocks]…."

**1989**
Act 118, SLH 1989, further amended language (including deletion of bracketed material) to "gross receipts from the sale of securities as defined in [section 485-1] 15 U.S.C. section 78c or similar laws of jurisdictions outside the United States, contracts for the sale of a commodity for future delivery and other agreements, options, and rights as defined in 7 U.S.C. section 2 that are permitted to be traded on a board of trade designated by the Commodities Futures Trading Commission under the Commodity Exchange Act, or [other] evidence of indebtedness[.]".

Although there is some data available for this exclusion, we do not report it here, as the figures would present an incomplete picture and would not reflect the total numbers of taxpayers and amounts excluded under the land sales exclusion. Additionally, DoTax does not consider any of these exclusions to be tax expenditures. According to DoTax, revenues from those activities are not meant to be subject to the GET.

### Are these exclusions necessary to promote or preserve tax equity or efficiency?

We concluded these exclusions promote tax efficiency. These sources of revenue were never intended to be part of the GET base, which caused the Legislature in 1935 to exclude revenues from these activities when it overhauled the then-Territory of Hawai‘i's tax scheme to tax business activities.

Gain from the sale of securities, land, and evidences of indebtedness is generally subject to taxes other than GET. Excluding these revenue items from GET liability prevents imposition of multiple taxes.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exclusions?

We determined that the primary purpose is not for any specific economic or employment benefit.

### Should these exclusions be retained without modification, amended, or repealed?

Because the exclusion for gross receipts from sales of securities, the exclusion for fee simple sales of improved or unimproved land, and the exclusion for evidences of indebtedness exclude revenue that the Legislature never intended be subject to GET, we recommend these exclusions be retained.

# Exemption for Reimbursements made to Federal Cost-Plus Contractors (Section 237-13(3)(C), HRS)

### Exemption at a Glance (2018)

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| $74.42 million | 29 | $372,115 | $0.78 | Yes |

### What does this exemption do?

The exemption for reimbursements made to federal cost-plus contractors allows contractors performing work under cost-plus contracts with the federal government[6] to deduct the cost of materials, plant, or equipment that is reimbursed to the contractor from its gross revenues subject to GET. The business from which the contractor purchased the materials, plant, or equipment must certify to DoTax that it will be responsible for payment of GET at the retail rate of 4 percent on the revenues received from the contractor for the materials, plant, or equipment. Taxpayers claiming these exemptions must also file DoTax's Schedule GE form and report the corresponding amounts as an exemption on their GET/Use Tax returns.

### How does this exemption work?

The federal government contracts with Contractor ABC to build a weather station at Kalaeloa Airport for the National Oceanic Atmospheric Administration. Under the contract, Contractor ABC is reimbursed its costs, including for materials, equipment, labor, and office expenses, plus an additional fee of $1 million. Contractor ABC incurs costs of $2 million for materials purchased from Acme Material Supply House and $1 million for its labor and other administrative expenses. The federal government reimburses Contractor ABC for its costs, i.e., the cost of materials and labor expenses, and pays Contractor ABC the additional fee of $1 million. Contractor ABC reports gross revenues of $4 million, but can deduct the cost of the materials ($2 million) from the amount subject to GET. Acme Material Supply

[6] A federal cost-plus contractor is defined by statute as a contractor having a contract with the United States in which the United States agrees to reimburse the contractor for the cost of material, plant, or equipment used in the performance of the contract, plus a profit on a fixed-fee or percentage basis.

### History of the Exemption

**1943**
Act 81, SLH 1943, established that taxpayers selling material, plant, or equipment to federal cost-plus contractors assume responsibility for paying the tax normally paid by federal cost-plus contractors.

**1971**
Act 204, SLH 1971, further expanded the definition of contractor and federal cost-plus contractor to include every person engaging in the practice of architecture, professional engineering, land surveying, and landscape architecture.

**1997**
The 1995-1997 Tax Review Commission recommended eliminating or limiting certain GET exemptions, including the exemption for reimbursements to federal cost-plus contractors.

**2011**
GET and Use Tax exemptions, including the exemption for reimbursements made to federal cost-plus contractors, were temporarily suspended for FY2012 and FY2013.

House must certify that it will pay GET on the gross revenue from the materials purchased by Contractor ABC for the weather station at the retail rate of 4 percent (or $80,000). Without the exemption, Acme Material Supply House would likely pay GET at the wholesale rate of 0.5 percent (or $10,000).

### What is the purpose of this exemption?

The Hawai‘i Revised Statutes do not directly state a purpose for this exemption. DoTax told us that the purpose of this exemption is to promote tax efficiency by eliminating the 0.5 percent wholesale GET liability incurred under a federal cost-plus contract. Under non-federal cost-plus contracts, contractors are responsible for GET on the reimbursement of their costs, likely at the 4 percent rate, and the contractors' material suppliers are responsible for GET on the revenue from the sale of the materials, likely at the 0.5 percent rate.

### Is this exemption meeting its purpose?

We found the exemption is meeting the purpose as understood by DoTax, at least with respect to cost-plus contracts with the federal government. Based on data obtained from DoTax, there were $74.42 million in claims for this exemption made by 29 taxpayers in 2018.

### What were the number of claimants, total amount claimed, and tax expenditures for this exemption from 2016-2018?

DoTax's methodology for calculating the tax expenditure for this exemption was to multiply all claims by the 0.5 percent wholesale rate. Our estimate likewise assumes that all suppliers pay GET at 4 percent on the revenues exempted by federal cost-plus contractors under this exemption. Based on that assumption, the effective cost of this exemption equates to the cost of eliminating the 0.5 percent wholesale GET that otherwise would apply to the suppliers' business activity.

Using this methodology, we calculate the estimated amount of the tax expenditures for 2016, 2017, and 2018 for this exemption as follows:

| Year | Number of Claimants | Amount Claimed | Tax Expenditure | DoTax Tax Expenditure |
|---|---|---|---|---|
| 2018 | 29 | $74.42 million | $372,115 | $352,000*** |
| 2017 | 57 | $75.08 million | $375,412 | $321,000** |
| 2016 | 41 | $80.87 million | $404,373 | N/A* |

Source: DoTAX report based on GET filings as of November 1, 2019.

Notes:
Figures in this table of less than $1 million are not rounded.
* DoTax did not publish data on tax expenditures in its 2016 report.
** DoTax data was based on returns for the filing period January 1 to December 31, 2017.
*** DoTax data was based on returns for the filing period as of November 5, 2019.

### Is the exemption necessary to promote or preserve tax equity or efficiency?

The purpose of this exemption appears to be to promote tax efficiency by eliminating the 0.5 percent wholesale GET liability incurred by material suppliers under a federal cost-plus contract. We conclude it promotes or preserves tax efficiency by reducing tax pyramiding.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exemption?

We determined that the primary purpose is not for any specific economic or employment benefit.

### Should the exemption be retained without modification, amended, or repealed?

Because the exemption for reimbursements made to federal cost-plus contractors works to eliminate tax pyramiding consistent with its purpose as related to us by DoTax, we recommend this exemption be retained.

### Issues of Concern

Under the statute, a seller of materials, plant, or equipment to a federal cost-plus contractor using this exemption must certify to DoTax that the seller will be responsible for payment of GET on the amounts exempted at the retail rate. DoTax's instructions for Schedule GE require submission of the certification with the contractor's return. However, we learned that DoTax does not require the certification to be submitted with the tax return, and deems certification to be satisfied by a statement given from the seller to the contractor. Without a copy of the certification, or at least information identifying the seller provided with the contractor's return, DoTax's ability to verify and enforce payment of GET at the retail rate based on returns is limited.

# Exclusion for Gross Receipts of Dividends (Section 237-3(b), HRS)

**Exemption at a Glance (2018)**

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| No data available | No data available | No data available | No data available | Yes |

## What does this exclusion do?

The exclusion on gross receipts of dividends excludes revenue from dividends and other similar distributions of income from being subject to GET. Taxpayers are not required to report to DoTax the amount of revenue from the dividends that they are excluding from GET.

## What is the purpose of this exclusion?

Neither Hawai‘i Revised Statutes nor the legislative history of Act 1, SLH 1957 (Special Session), contain a statement of purpose. However, as explained in a 2013 article written by a DoTax tax research and planning officer, the GET law "is worded so broadly that without explicit exemptions, it would apply to many sales that are not properly part of a broad-based tax on income or consumption. For example, GET contains exemptions for … sales of stocks and bonds, … sales of land in fee simple … items (that) have no proper place in the base of a sales or excise tax." We infer the purpose of the exclusion is to remove this revenue from the GET base as a matter of policy.

## Is this exclusion meeting its purpose?

According to DoTax, because dividends are excluded from the definition of income and sales revenue subject to GET, the exclusion does not result in a tax expenditure, as revenue from this activity was never intended to be taxed. The exclusion is meeting its purpose, as we infer that purpose to be.

## What were the number of claimants, total amount claimed, and tax expenditures for this exclusion from 2016-2018?

DoTax does not currently track data relating to the exclusion.

### History of the Exclusion

**1957**
Act 1, SLH 1957 (Special Session), amended state tax law by excluding dividends from the definition of income and sales subject to GET.

### Is the exclusion necessary to promote or preserve tax equity or efficiency?

We found the exclusion is meeting its purpose, to the extent that it was intended to prevent taxation on gross receipts of dividends. Additionally, as noted earlier, under the concept of efficiency, a tax system should avoid hindering economic goals, such as economic growth, capital formation, and competitiveness with other jurisdictions. Therefore, the exclusion promotes tax efficiency by not subjecting revenue derived from dividends and other distributions to both income tax and GET.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exclusion?

We determined that the primary purpose is not for any specific economic or employment benefit.

### Should the exclusion be retained without modification, amended, or repealed?

The exclusion on gross receipts of dividends works to exclude revenue from dividends and other distributions from the GET base, which is our understanding of its underlying tax policy. We recommend this exclusion be retained.

# Exclusion for Gross Receipts from Sales or Transfers of Materials and Supplies, Interest on Loans, and Provision of Services Among Members of an Affiliated Public (Utility) Service Company Group (Section 237-3(b), HRS)

**Exemption at a Glance (2018)**

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| No data available | No data available | No data available | No data available | Yes |

### What does this exclusion do?

The exclusion on gross receipts from sales or transfers of materials and supplies, interest on loans, and provision of services among members of an affiliated public (utility) service company group allows public service companies or utilities to exclude revenue from certain intracompany transactions from GET. Businesses are not required to report revenue from such sales or transfers that they are excluding from GET.

### How does this exclusion work?

O‘ahu Electric Company and Mahalo Power, Inc., two fictional Hawai‘i companies, provide electrical service to Kāne‘ohe and Ko Olina, respectively. Both are public utilities regulated by the Hawai‘i Public Utilities Commission. Mahalo Power, Inc. is a subsidiary of Aloha Electric Company and sells 10 utility poles to Aloha Electric Company for $50,000. Mahalo Power, Inc.’s revenue from the sale of the utility poles ($50,000) is not subject to GET.

### What is the purpose of this exclusion?

The legislative history of this provision notes the purpose is to eliminate the taxation of certain transactions, which should result in lower net utility costs that would benefit rate-paying customers of those utilities. Under prior law, taxes on intercompany transactions could be avoided simply by eliminating the legal status of subsidiary companies and operating them as divisions of the parent company. As noted in its Committee Report, the House Committee on Consumer Protection and Commerce felt that public utilities and their consumers should not be penalized merely because of a technicality relating to corporate structure.

### History of the Exclusion

**1977**
Act 26, SLH 1977, amended the definition of “gross income” and “gross proceeds of sales” to exclude gross receipts from various sales and transfers by one member of an “affiliated public service company group” to another member of the same group.

### Is this exclusion meeting its purpose?

We found the exclusion is meeting its purpose, to the extent that it was intended to prevent taxation on certain intracompany transactions. We identified at least one Hawai‘i public service company that utilized the exclusion. However, we are unable to determine whether tax savings from the exclusion resulted in any reduction of costs to rate-paying customers.

### What were the number of claimants, total amount claimed, and tax expenditures for this exclusion from 2016-2018?

DoTax does not require public service companies that exclude revenues from transactions with affiliated public service companies to report the excluded income from those intercompany transactions. For that reason, DoTax does not maintain any data as the number of public service companies that benefit from the exclusion or the amount of revenue that those companies excluded from GET. DoTax does not consider the amounts excluded under this provision to be tax expenditures.

### Is the exclusion necessary to promote or preserve tax equity or efficiency?

The tax provision excludes intracompany transactions from being subject to taxation, eliminating the incentive for public service companies to change legal structure solely to avoid taxes. We conclude this exclusion promotes tax efficiency.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exclusion?

We determined that the primary purpose is not for any specific economic or employment benefit.

### Should the exclusion be retained without modification, amended, or repealed?

Because the exclusion appears to be meeting its purpose, we recommend this exclusion be retained.

# Exclusion for Gross Receipts of Home Service Providers Acting as Service Carriers (Section 237-13(6)(D)(i),(ii),(iii), and (iv), HRS)

### Exclusion at a Glance (2018)

| Amount claimed | Number of Unique Claimants | Tax Expenditure | Cost Per Low-Income Resident | Meeting its Purpose? |
|---|---|---|---|---|
| No data available | No data available | No data available | No data available | Yes |

### What is the purpose of this exclusion?

The legislative history of the exclusion indicates the purpose is to simplify filing and reporting of long-distance wireless calls to conform Hawai‘i law with the federal Mobile Telecommunications Sourcing Act of 2000.

### What does this exclusion do?

The exclusion on gross receipts of home service providers acting as service carriers allows Hawai‘i wireless telecommunications companies to avoid GET on revenue from wholesale sales of mobile telecommunication services between different home service providers.[7] These sales occur when customers make wireless calls to or from Hawai‘i through home service providers not licensed by the Federal Communications Commission (FCC) to operate in the State. In those cases, the customer's home wireless provider must purchase mobile telecommunications service from a provider that holds an FCC license for Hawai‘i. The exemption excludes income from these sales that would normally be subject to Hawai‘i's GET. Businesses are not required to report to DoTax the amount of revenue from the receipts from home service providers that they are excluding from GET.

### Is this exclusion meeting its purpose?

We found the exclusion is meeting its purpose to the extent that it conforms Hawai‘i law to federal law.

[7] Mobile telecommunication providers serving customers within specific boundaries are referred to as home service providers.

### History of the Exclusion

**2002**
Act 209, SLH 2002, excluded sales of mobile telecommunication services made between home service providers from both the GET and Public Service Company Tax. In addition, Act 209 conformed state tax code with the federal Mobile Telecommunications Sourcing Act, under which all wireless calls are sourced to the customers' residence or primary business street address. In addition, Act 209 expanded the State's taxing authority by allowing Hawai‘i to tax transactions completely outside of the State's borders, if the customer has a place of primary use in Hawai‘i.

**2011**
GET and Use Tax exemptions, including the exclusion on gross receipts of home service providers acting as service carriers, were temporarily suspended for FY2012 and FY2013.

### What were the number of claimants, total amount claimed, and tax expenditures for this exclusion from 2016-2018?

DoTax does not require revenue from sales of mobile telecommunication services made between home service providers to be reported on GET returns. For that reason, DoTax does not maintain any data relating to the use of the exclusion. The Public Utilities Commission reports that there are 177 telecommunications carriers operating in Hawai‘i.

### Is the exclusion necessary to promote or preserve tax equity or efficiency?

This exclusion promotes tax efficiency. If Hawai‘i law did not conform to federal law and provide for an exclusion of these amounts, Hawai‘i service providers would face a tax situation inconsistent with federal law.

### Is there an economic or employment benefit and if so, does the benefit outweigh the cost of the exclusion?

We determined that the primary purpose is not for any specific economic or employment benefit.

### Should the exclusion be retained without modification, amended, or repealed?

According to DoTax and CTIA, a trade association representing the wireless communications industry in the United States, a repeal of this exemption would have little practical effect. Since the taxation of wholesale charges provided to a home service provider are pre-empted from taxation by federal law, there would be no revenue impact from eliminating the exclusion. However, without the exclusion, Hawai‘i’s law would conflict with federal law. We recommend this exclusion be retained.

## Recommendations

1. For new tax credits, exemptions, and exclusions, the Legislature should include (1) a clear statement of the purpose of the tax provision and (2) objective criteria to determine whether the tax preference is meeting that purpose. As part of our reviews, we are to determine, among other things, whether the tax provision "has achieved and continues to achieve the purpose for which it was engaged by the Legislature." Without a statement of legislative intent for each tax provision as well as specific metrics to assess whether the provision is meeting the intended purpose, we will not be able to report important information for many provisions and likely cannot assess whether the benefit outweighs the cost of the preference.

   A similar approach has been taken by the State of Washington, whose Legislature has noted this type of additional detail, such as demographics to be used to measure effectiveness, is important to facilitating future reviews of its tax preferences.

2. For the same reasons, the Legislature should amend current tax credits, exemptions, and exclusions to include (1) a clear statement of the purpose of the tax provision and (2) objective criteria to determine whether the tax preference is meeting that purpose.

3. Taxpayers claiming an exemption from GET or Use Tax should be required to provide specific data as part of their filing to demonstrate how the tax preference supports business growth. For example, businesses could be required to attest to and provide documentation on the number of jobs, the total amount in wages, or other metrics directly related to a preference that is intended to provide an economic or employment benefit to the State. Such information would yield important data we need to provide more meaningful information about the actual benefits associated with a particular tax preference that the Legislature can consider as it evaluates whether to retain, modify, or repeal the provision.

4. Section 237-3(b), HRS – Exclusions from the definitions of "gross income" and "gross proceeds of sale":

   This provision has been amended many times since its initial enactment in 1935, often in piecemeal fashion. This has resulted in a disjointed, often confusing statute, with a series of clauses separated by commas and semi-colons.

For example, the "sales of evidence of indebtedness" exclusion, which we reviewed in this report, was originally an exclusion for "sale of bonds or other evidence of indebtedness." After several amendments, the reference to bonds was removed. In its current form, the exclusion is vague and unclear, which hindered our ability to assess the provision as required by Section 23-72(c)(1)(C), HRS.

DoTax should review and propose revisions to this subsection to clarify these exclusions from the definitions of "gross income" and "gross proceeds of sale."

5. Section 237-13(3)(B), HRS – Gross income of contractors from subcontractors exemption:

   Contractors seeking a GET exemption for gross revenue paid to subcontractors are required to provide the names and GET license numbers of those subcontractors on their GET filings. DoTax, however, has not enforced that requirement. A number of GET filings we reviewed were missing the required information. To claim the exemption, DoTax should ensure contractors provide the required information about subcontractors. In addition, the department should also verify and cross-reference this information to ensure subcontractors pay required GET at the retail GET rate of 4 percent on receipts exempted by contractors.

   We also are unclear whether the name and GET license number of the subcontractor provides sufficient information for DoTax to verify the subcontractor is paying GET at the required rate of 4 percent on revenue exempted by a contractor. We assume some contractors are engaged on multiple projects simultaneously, that each project may involve many subcontractors, that some subcontractors also are engaged on multiple projects simultaneously under different contractors, and that some of those subcontractors also exempt revenues paid to their sub-subcontractors. Currently, taxpayers (contractors and subcontractors) claiming the exemption from GET for revenues paid to their respective subcontractors are not required to identify the project, the project owner, or the developer, nor to provide any other project-specific information that would assist tracking of exempted amounts.

   If DoTax is unable to verify that subcontractors paid GET at the 4 percent rate on revenues contractors deducted, DoTax should identify the added information that must be filed to ensure receipts exempted by contractors are actually remitted by subcontractors and require that information to be provided as part of the filing claiming the exemption. This additional information could include project-level cost data instead of aggregate data to provide transparency for transactions in which the exemption is claimed by prime contractor as well as one or more subcontractors, who may also have hired subcontractors of their own.

6. Section 237-24.3(11), HRS; Section 238-1, HRS, paragraph (6) of the definition of "use" – GET and Use Tax exemptions for aircraft and aircraft engine rental or leasing:

    a. The "General Excise/Use Tax Return" form does not allow taxpayers to report revenue subject to GET separately from amounts subject to Use Tax. Taxpayers report amounts subject to GET and Use Tax as a single, consolidated amount on the form.

       As a result, DoTax cannot determine the number of taxpayers deducting revenue from GET or the amount of those claims. Likewise, DoTax cannot determine the number of taxpayers claiming the Use Tax exemption. Without that specific information, we have no ability to review and assess the use of the GET and Use Tax exemptions except in the aggregate.

       DoTax should require filers to claim GET and Use Tax exemptions separately. Without separate reporting, there is no way to distinguish the level of activity generated by in-state and offshore businesses that may be benefitting from these exemptions. We suggest this greater transparency and information is meaningful and important to oversee DoTax's administration of tax expenditures. We believe detailed data would help legislators and the public better understand how exemptions are used and whether they are effective.

    b. Based on legislative history, we inferred that the purpose of the exemptions are to support interisland air carriers. However, based on the relatively small number of claimants and, more importantly, the relatively small amount of tax expenditure, the exemption very likely has little impact, if any, on the interisland air carrier industry. We suggest GET and Use Tax exemptions may not be the most effective way to support the interisland air carriers and the Legislature should consider repealing the exemptions and any requirements for their review.

7. Section 237-24.9, HRS; Section 238-1, HRS, paragraph (8) of the definition of "use" – GET and Use Tax exemptions for aircraft servicing and maintenance facility construction:

   a. For the reasons expressed above relating to GET and Use Tax exemptions for aircraft and aircraft engine rental or leasing, DoTax should require separate reporting of GET and Use Tax claims for aircraft servicing and maintenance facility construction to provide greater transparency and information to the Legislature and the public about the use of each exemption.

   b. We also recommend that DoTax require claimants to report amounts claimed for aircraft servicing and maintenance separately from amounts claimed for maintenance facility construction. Currently, the data is aggregated and not tracked by activity. Discrete exemption data would help legislators and the public better understand how the exemptions are used and whether they are effectively achieving policy goals in this area.

8. Section 237-13(3)(C) – Exemption for reimbursements made to federal cost-plus contractors:

   Under the statute, a *taxpayer making a sale to a federal cost-plus contractor* using this exclusion shall certify to DoTax that the *taxpayer* is "taxable with respect to the gross proceeds of the sale, and that the taxpayer elects to have the tax on gross income computed the same as upon a sale to the state government."

   DoTax's instructions for the Schedule GE form pertaining to federal cost-plus contractors appear to be inconsistent with requirements contained in the statute. The instructions state the following (highlighted), applying the certification requirement to the contractor, not the taxpayer:

   ***Federal Cost-Plus Contractors:*** *If you are a federal cost-plus contractor, you may elect to deduct any amounts that you were reimbursed under the contract for materials, plant, or equipment. Report these amounts with ED Code 117 on the Schedule GE (Form G-45/G-49).* ***In addition, you must certify that you are taxable with respect to the gross proceeds of the sale, and that you elect to have the tax on the gross income computed the same as upon a sale to the state government.*** *Please attach the certification on a separate sheet. (Section 237-13(3)(C).)*

   As DoTax's instructions do not conform to the statute's plain language and raise doubt as to whether the law is being applied as written, we recommend DoTax conform its instructions to comply with the language from the statute.

9. Section 237-24.5, HRS – Exemption for amounts received by securities exchanges or exchange members:

   Although the purpose of this exemption is to attract a securities exchange to Hawaiʻi, no exchange has been established. Accordingly, the Legislature should repeal both the exemption and the requirement for its review.

10. Finally, we recommend that the following exclusions be removed from future review, pursuant to Section 23-71(c), HRS:

    a. Section 23-72(c)(1), HRS (Section 237-3(b), HRS) – Gross receipts from the following:

       (1) Sales of securities;
       (2) Sales of commodities futures;
       (3) Sales of evidences of indebtedness;
       (4) Fee simple sales of improved or unimproved land;
       (5) Dividends; and
       (6) Sales or transfers of materials and supplies, interest on loans, and provision of services among members of an affiliated public service company group.

    b. Section 23-72(c)(4), HRS (Section 237-13(6)(D)(i), (ii), (iii), and (iv), HRS) – Gross receipts of home service providers acting as service carriers.

    These exclusions eliminate taxes on activities the Legislature did not intend to include in the broad GET base. As a result, these tax provisions do not have an associated "tax expenditure" cost. In addition, DoTax does not require claimants to file GET returns or other documents to exclude revenue from those activities. Because revenues excluded are not reported, there is no data upon which to assess these provisions. Therefore, unless DoTax requires claimants to report the revenues they are excluding under these provisions, future review of these provisions is not warranted. If, however, the Legislature determines that it would like these provisions to be assessed, the Legislature should direct DoTax to report and track data associated with the use of the exclusions.

# Appendix A
## Schedule of Tax Statutes for Review

Sections 71-81, HRS
Sections 91-96, HRS

| Report Date | HRS Ref. | Statute to be reviewed | Notes |
|---|---|---|---|
| 2020 Sess. | 23-72 | Section 237-3(b) | Gross receipts from the following: (A) Sales of securities; (B) Sales of commodity futures; (C) Sales of evidences of indebtedness; (D) Fee simple sales of improved or unimproved land; (E) Dividends; and (F) Sales or transfers of materials and supplies, interest on loans, and provision of services among members of an affiliated public service company group |
| | | 237-13(3)(B) | Gross income of contractors from subcontractors |
| | | 237-13(3)(C) | Reimbursements to federal cost-plus contractors |
| | | 237-13(6)(D)(i),(ii), (iii), and (iv) | Gross receipts of home service providers acting as service carriers |
| | | 237-24.3(11) | Amounts received from aircraft and aircraft engine rental or leasing |
| | | 237-24.9 | Amounts received from aircraft servicing and maintenance and aircraft service and maintenance facility construction |
| | | Section 238-1, paragraph (6) | Definition of "use" – The value of aircraft leases or rental and acquired or imported aircrafts and aircraft engines |
| | | Section 238-1, paragraph (8) | Definition of "use" – The value of material, parts, or tools for aircraft service and maintenance and aircraft service and maintenance facility construction |
| 2021 Sess. | 23-73 | 237-16.5 | Gross income of real property lessees from sublessees |
| | | 237-16.8 | Value or gross income of nonprofit organizations from conventions, conferences, trade shows, and display spaces |
| | | 349-10 | Proceeds earned from annual senior citizen's fairs |
| | | 237-23.5 | Amounts received from common payments of related entities |
| | | 237-24(13) | Amounts received by blind, deaf, or totally disabled persons from their business |
| | | 237-24(14) | Amounts received by independent cane farmers who are sugarcane producers |
| | | 237-24(15) | Amounts received by foster parents |
| | | 237-24(16) | Reimbursements to cooperative housing corporations for operating and maintenance expenses |
| | | 237-24(17) | Amounts received by TRICARE managed care support contractors |
| | | 237-24(18) | Amounts received by Patient-Centered Community Care program contractors |
| | 23-92 | 235-12.5 | Credit for renewable energy technology system installed and placed in service in the State. For the purpose of section 23-91(b)(5), this credit shall be deemed to have been enacted for an economic benefit |
| | | 241-4.6 | Credit for renewable energy technology system installed and placed in service in the State. For the purpose of section 23-91(b)(5), this credit shall be deemed to have been enacted for an economic benefit |
| | | 235-17 | Credit for qualified production costs incurred for a qualified motion picture, digital media, or film production |

| Report Date | HRS Ref. | Statute to be reviewed | Notes |
|---|---|---|---|
| 2022 Sess. | 23-74 | Section 239-2, paragraph (5) | Definition of "gross income" – Gross income of home service providers of mobile telecommunications services |
| | | Section 239-2 | Exclusions under the definition of "gross income" – Dividends paid by one member to another member of an affiliated public service company group or gross income from the sale or transfer of materials and supplies, interest on loans, and provision of services among members of an affiliated public service company group |
| | | 237-3(b) | Gross receipts from the sale or transfer of materials and supplies, interest on loans, and provision of services among members of an affiliated public service company group |
| | | 239-5.5 | Gross income of utilities from monthly surcharges |
| | | 239-6.5 | Tax credit for lifeline telephone service subsidies |
| | | 269-172 | Green infrastructure charges received by electric utilities |
| | | 237-29.7 | Gross income or gross proceeds received by insurance companies |
| | | 431:7-207 | Tax credit to facilitate regulatory oversight |
| | | 432:1-403 | Exemption for nonprofit medical indemnity or hospital service associations or societies specifically from the general excise tax, public service company tax, or insurance premium tax |
| | | 432:2-503 | Exemption for fraternal benefit societies specifically from the general excise tax, public service company tax, or insurance premium tax |
| | 23-93 | 235-7.3 | Exclusion of royalties and other income derived from a patent, copyright, or trade secret of a qualified high technology business |
| | | 235-9.5 | Exclusion for income and proceeds from stock options or stocks of a qualified high technology business or a holding company for a qualified high technology business |
| | | 235-17.5 | Credit for capital infrastructure costs |
| | | 241-4.4 | Credit for capital infrastructure costs |
| | | 235-110.7 | Credit for capital goods used by a trade or business |
| | | 241-4.5 | Credit for capital goods used by a trade or business |
| | | 235-110.91 | Credit for research activity |
| | | 235-110.3 | Credit for ethanol facility |
| | | 241-3.5 | Deduction for adjusted eligible net income of an international banking facility |

| Report Date | HRS Ref. | Statute to be reviewed | Notes |
|---|---|---|---|
| 2023 Sess. | 23-75 | 237-24.3(1) | Amounts received from loading, transporting, and unloading agricultural commodities shipped interisland |
| | | 237-24.3(3)(A) | Amounts received from cargo loading or unloading |
| | | 237-24.3(3)(B) | Amounts received from tugboat and towage services |
| | | 237-24.3(3)(C) | Amounts received from the transportation of pilots or government officials and other maritime-related services |
| | | Section 238-1, paragraph (7) | Definition of "use" – The value of oceangoing vehicles for transportation from one point to another in the State |
| | | 238-3(g) | The value of imported intoxicating liquor and cigarettes and tobacco products for sale to persons or common carriers in interstate commerce |
| | | 238-3(h) | The value of vessels constructed under section 189-25, relating to commercial fishing vessel loans, prior to July 1, 1969 |
| | | 237-28.1 | Gross proceeds from shipbuilding and ship repair |
| | 23-94 | 235-4.5(a) | Exclusion of intangible income earned by a trust sited in this State |
| | | 235-4.5(b) | Exclusion of intangible income of a foreign corporation owned by a trust sited in this State |
| | | 235-4.5(c) | Credit to a resident beneficiary of a trust for income taxes paid by the trust to another state |
| | | 235-55 | Credit for income taxes paid by a resident taxpayer to another jurisdiction |
| | | 235-129 | Credit for income taxes paid by a resident taxpayer to another jurisdiction |
| | | 235-71(c) | Credit for a regulated investment company shareholder for the capital gains tax paid by the company |
| | | 235-110.6 | Credit for fuel taxes paid by a commercial fisher |
| | | 235-110.93 | Credit for important agricultural land qualified agricultural cost |
| | | 235-110.94 | Credit for organically produced agricultural products |
| | | 235-129(b) | Credit to a shareholder of an S corporation for the shareholder's pro rata share of the tax credit earned by the S corporation in this State |
| | | 209E-10 | Credit for a qualified business in an enterprise zone; provided that the review of this credit pursuant to this part shall be limited in scope to income tax credits |

| Report Date | HRS Ref. | Statute to be reviewed | Notes |
|---|---|---|---|
| 2024 Sess. | 23-76 | 237-24.3(4) | Amounts received by employment benefit plans and amounts received by nonprofit organizations or offices for the administration of employee benefit plans |
| | | 237-24.3(5) | Amounts received from food coupons under the federal food stamp program or vouchers under the Special Supplemental Foods Program for Women, Infants and Children |
| | | 237-24.3(6) | Amounts received from the sale of prescription drugs or prosthetic devices |
| | | 237-24.3(8) | Amounts received as dues by unincorporated merchants associations for advertising or promotion |
| | | 237-24.3(9) | Amounts received by labor organizations from real property leases |
| | | 237-24.75(2) | Reimbursements to the Hawaii convention center operator from the Hawaiʻi Tourism Authority |
| | | 237-24.75(3) | Reimbursements to professional employer organizations from client companies for employee wages and fringe benefits |
| | | 209E-11 | Amounts received by qualified businesses in enterprise zones |
| | 23-95 | 235-5.5 | Deduction for individual housing account deposit |
| | | 235-7(f) | Deduction of property loss due to a natural disaster |
| | | 235-16.5 | Credit for cesspool upgrade, conversion, or connection |
| | | 235-19 | Deduction for maintenance of an exceptional tree |
| | | 235-55.91 | Credit for the employment of a vocational rehabilitation referral |
| | | 235-110.2 | Credit for in-kind services contribution for public school repair and maintenance |
| | | 235-110.8 | Credit for ownership of a qualified low-income housing building |
| | | 241-4.7 | Credit for ownership of a qualified low-income housing building |
| 2025 Sess. | 23-77 | 237-24.3(2) | Reimbursements to associations of owners of condominium property regimes or nonprofit homeowners or community associations for common expenses |
| | | 237-24.5 | Amounts received by exchanges or exchange members* |
| | | 237-25(a)(3) | Gross income received from tangible personal property sales to state-chartered credit unions |
| | | 237-24.8 | Amounts received by financial institutions, trust companies, trust departments, or financial corporations acting as interbank brokers |
| | | 237-26 | Gross proceeds of scientific contractors and subcontractors |
| | | 238-3(j) | The value of property or services exempted by section 237-26, relating to scientific contracts |
| | | 237-27 | Amounts received by petroleum product refiners from other refiners |
| | 23-96 | 235-15 | Credit for purchase of child passenger restraint system |
| | | 235-55.6 | Credit for employment-related expenses for household and dependent care services |
| | | 235-55.7 | Credit for a low-income household renter |
| | | 235-55.85 | Credit for food and excise tax |

* Note: This exemption was reviewed in the report to the 2020 Legislature.

| Report Date | HRS Ref. | Statute to be reviewed | Notes |
|---|---|---|---|
| 2026 Sess. | 23-78 | 237-24.7(1) | Amounts received by hotel operators and hotel suboperators for employee wages and fringe benefits |
| | | 237-24.7(2) | Amounts received by a county transportation system operator under a contract with the county |
| | | 237-24.7(4) | Amounts received by orchard property operators for employee wages and fringe benefits |
| | | 237-24.7(6) | Amounts received from insurers for damage or loss of inventory of businesses located in a natural disaster area |
| | | 237-24.7(7) | Amounts received by community organizations, school booster clubs, and nonprofit organizations for precinct and other election-related activities |
| | | 237-24.7(8) | Interest received by persons domiciled outside the State from trust companies acting as payment agents or trustees on behalf of issuers or payees of interest-bearing instruments or obligations |
| | | 237-24.7(9) | Amounts received by management companies from related entities engaged in interstate or foreign common carrier telecommunications services for employee wages and fringe benefits |
| | | 237-24.7(10) | Amounts received from high technology research and development grants |
| | 23-92 | 235-12.5 | Credit for renewable energy technology system installed and placed in service in the State. For the purpose of section 23-91(b)(5), this credit shall be deemed to have been enacted for an economic benefit |
| | | 241-4.6 | Credit for renewable energy technology system installed and placed in service in the State. For the purpose of section 23-91(b)(5), this credit shall be deemed to have been enacted for an economic benefit |
| | | 235-17 | Credit for qualified production costs incurred for a qualified motion picture, digital media, or film production |

| Report Date | HRS Ref. | Statute to be reviewed | Notes |
|---|---|---|---|
| 2027 Sess. | 23-79 | 237-27.5 | Gross proceeds from air pollution control facility construction, reconstruction, operation, use, maintenance, or furnishing |
| | | 238-3(k) | The value of air pollution control facilities |
| | | 237-27.6 | Amounts received by solid waste processing, disposal, and electric generating facility operators under sale and leaseback transactions with political subdivisions that involve the facilities |
| | | 237-29 | Gross income of qualified persons or firms or nonprofits or limited distribution mortgagors for certified or approved low-income housing projects |
| | | 238-3(j) | The value of property, services, or contracting exempted by Section 237-29, relating to certified or approved housing projects |
| | | 431:7-208 | Credit for low-income housing |
| | | 46-15.1(a) | Gross income from county low-income housing projects |
| | | 346-369 | Compensation received by provider agencies for homeless services or homeless facility management |
| | 23-93 | 235-7.3 | Exclusion of royalties and other income derived from a patent, copyright, or trade secret of a qualified high technology business |
| | | 235-9.5 | Exclusion for income and proceeds from stock options or stocks of a qualified high technology business or a holding company for a qualified high technology business |
| | | 235-17.5 | Credit for capital infrastructure costs |
| | | 241-4.4 | Credit for capital infrastructure costs |
| | | 235-110.7 | Credit for capital goods used by a trade or business |
| | | 241-4.5 | Credit for capital goods used by a trade or business |
| | | 235-110.91 | Credit for research activity |
| | | 235-110.3 | Credit for ethanol facility |
| | | 241-3.5 | Deduction for adjusted eligible net income of an international banking facility |

| Report Date | HRS Ref. | Statute to be reviewed | Notes |
|---|---|---|---|
| 2028 Sess. | 23-80 | 237-29.5 | Value or gross proceeds from tangible personal property shipped out of State |
| | | 237-29.53 | Value or gross income from contracting or services performed for use outside the State |
| | | Section 238-1, paragraph (9) | Definition of "use" – The value of services or contracting imported for resale, consumption, or use outside the State |
| | | 237-29.55 | Gross proceeds or gross income from the sale of tangible personal property imported into the State for subsequent resale |
| | 23-94 | 235-4.5(a) | Exclusion of intangible income earned by a trust sited in this State |
| | | 235-4.5(b) | Exclusion of intangible income of a foreign corporation owned by a trust sited in this State |
| | | 235-4.5(c) | Credit to a resident beneficiary of a trust for income taxes paid by the trust to another state |
| | | 235-55 | Credit for income taxes paid by a resident taxpayer to another jurisdiction |
| | | 235-129 | Credit for income taxes paid by a resident taxpayer to another jurisdiction |
| | | 235-71(c) | Credit for a regulated investment company shareholder for the capital gains tax paid by the company |
| | | 235-110.6 | Credit for fuel taxes paid by a commercial fisher |
| | | 235-110.93 | Credit for important agricultural land qualified agricultural cost |
| | | 235-110.94 | Credit for organically produced agricultural products |
| | | 235-129(b) | Credit to a shareholder of an S corporation for the shareholder's pro rata share of the tax credit earned by the S corporation in this State |
| | | 209E-10 | Credit for a qualified business in an enterprise zone; provided that the review of this credit pursuant to this part shall be limited in scope to income tax credits |

| Report Date | HRS Ref. | Statute to be reviewed | Notes |
|---|---|---|---|
| 2029 Sess. | 23-81 | 237-23(a)(3) | Fraternal benefit societies, orders, or associations for the payment of benefits to members |
| | | 237-23(a)(4) | Corporations, associations, trusts, or societies: (A) Organized and operated exclusively for religious, charitable, scientific, or educational purposes; (B) Operating senior citizens housing facilities qualifying for loans under the United States Housing Act of 1959, as amended; (C) Operating legal service plans; or (D) Operating or managing homeless facilities or other programs for the homeless |
| | | 237-23(a)(5) | Business leagues, chambers of commerce, boards of trade, civic leagues, agricultural and horticultural organizations, and organizations operated exclusively for the benefit of the community or promotion of social welfare, including legal service plans |
| | | 237-23(a)(6) | Hospitals, infirmaries, and sanitaria |
| | | 237-23(a)(7) | Tax-exempt potable water companies serving residential communities lacking access to public utility water services |
| | | 237-23(a)(8) | Agricultural cooperative associations incorporated under state or federal law |
| | | 237-23(a)(9) | Persons affected with Hansen's disease and kokuas with respect to business within the county of Kalawao |
| | | 237-23(a)(10) | Corporations, companies, associations, or trusts organized for cemeteries |
| | | 237-23(a)(11) | Nonprofit shippers |
| | 23-95 | 235-15 | Credit for purchase of child passenger restraint system |
| | | 235-55.6 | Credit for employment-related expenses for household and dependent care services |
| | | 235-55.7 | Credit for a low-income household renter |
| | | 235-55.85 | Credit for food and excise tax |

# Appendix B

## Impact on "Low-Income Residents"

Section 23-71, HRS, also requires us to estimate the "annual cost of the exemption [or] exclusion... per low-income resident of the State." The statute defines "low-income resident" as a state resident who is (1) the only member of a family of one and has an income of not more than 80 percent of the area median income for a family of one; or (2) part of a family with an income of not more than 80 percent of the area median income for a family of the same size. Applying this definition, there were an estimated 479,714 "low-income residents" statewide in 2017, based on data provided by DBEDT.

The results of this evaluation follow and only include costs for the tax provisions with reportable data.

### Cost of Exemptions and Exclusions per "Low-Income Resident"

| Statute | Tax incentive | 2018 Cost | Cost per "low-income resident" |
|---|---|---|---|
| **Section 237-13(3)(B)** | Gross income of contractors from subcontractors | $ 20.68 million | $ 43.12 |
| **Section 237-13(3)(C)** | Reimbursements to federal cost-plus contractors | $ 372,115 | $ 0.78 |
| **Section 237-24.3(11); Section 238-1, paragraph (6) of the definition of "use"** | Amounts received from aircraft and aircraft engine rental or leasing | $ 1.97 million | $ 4.11 |
| **Section 237-24.9; Section 238-1, paragraph (8) of the definition of "use"** | Amounts received from aircraft servicing and maintenance and aircraft service and maintenance facility construction | $ 1.53 million | $ 3.20 |

Source: Auditor research.

Although we conducted this analysis using the formula set forth by statute, we question whether the results above represent the value to "low-income residents" of repeal of a particular exemption or exclusion. Although money generated from repealing a particular exemption or exclusion likely will increase tax revenues, the impact of the additional funds will not automatically accrue a benefit to "low-income residents," in particular, but to all residents. Therefore, to the extent that the Legislature considers a tax credit or rebate to low-income residents to offset this cost, a more accurate representation of impact may be to divide the amount of cost by all residents, not just low-income residents.

The following table contrasts 2018 GET data with Hawai‘i’s total 2018 population of 1,420,491 people.

## Cost of Exemptions per Hawai‘i Resident

| Tax incentive | 2018 Cost | Cost per resident |
|---|---|---|
| Gross income of contractors from subcontractors | $ 20.68 million | $ 14.56 |
| Reimbursements to federal cost-plus contractors | $ 372,115 | $ 0.26 |
| Amounts received from aircraft and aircraft engine rental or leasing | $ 1.97 million | $ 1.39 |
| Amounts received from aircraft servicing and maintenance and aircraft service and maintenance facility construction | $ 1.53 million | $ 1.08 |

Source: Auditor research.

# Office of the Auditor's Comments on the Department of Taxation's Response to the Draft Copy of Report

**THE DEPARTMENT OF TAXATION (DOTAX)** provided comments to our report, which are included in their entirety as Attachment 1. DoTax did not express any material disagreements with our analyses or findings, but offered some comments for our consideration.

DoTax suggested the addition of clarifying language to tax collection figures and tax expenditure methodology. We believe that the draft was adequately clear on these points, but DoTax's concerns are noted and briefly discussed below.

DoTax suggested some clarification on the figures contained in Exhibit 1.1. We reviewed the exhibit and made changes, as we deemed appropriate.

DoTax also suggested additional clarifying labels to distinguish between "DOTAX Tax Expenditure" and "Auditor Tax Expenditure" where applicable. We provide a detailed explanation of the differences in methodology on page 8 of our report (Tax Expenditures: At What "Cost"?) that we believe adequately explains these differences.

DoTax also suggested we clarify that the 2018 data used in some of our tables is updated and therefore different from the "Hawai'i General Excise & Use Tax Exemptions, Tax Year 2018" report. We do note on page 8 of our report that: "[t]here are also some differences in the total amounts claimed for the exemptions; these differences are due to updated DoTax data used in our report." Where updated data was used, we noted this – e.g., by saying the data was "based on returns for the filing period as of November 5, 2019."

As to the specific comments DoTax made to some of our recommendations, we respond as follows:

### Recommendation #3:

We reported our inability to analyze whether exemptions whose purpose is to support business growth are achieving that purpose because of the lack of data. We recommended that taxpayers claiming certain exemptions be required to provide information such as the number of jobs, the total amount of wages, or other metrics directly attributable to the tax exemption as part of their GET filing.

DoTax noted that requiring reporting of that type of data "would add additional burden to taxpayers and the [d]epartment." DoTax suggested the Legislature should create "certifying agenc[ies]" that review and certify taxpayer exemption claims. DoTax misconstrues the purpose of our recommendation. While we believe there should be review and confirmation of exemption claims, we assume that responsibility is performed by DoTax through, among other things, taxpayer audits. We do not have data suggesting taxpayers are improperly claiming exemptions that justify creating new State agencies to review and certify taxpayer exemption claims.

Consolidated data specific to each tax exemption is necessary for the Legislature to evaluate whether the provision should be retained, modified, or repealed. While receiving and consolidating such data will be an additional responsibility, DoTax is best positioned to do so. Taxpayers claiming certain exemptions, such as the contractor-subcontractor exemption and the federal cost-plus contractor exemption, are currently required to submit certifications and provide other data to DoTax.

### Recommendation #5:

We reported DoTax does not enforce the requirement that contractors exempting gross revenue paid to their subcontractors provide the names and GET license numbers of those subcontractors on their GET filings. In its response, DoTax noted that, starting in July 2020, GET filers will be required to file electronically, enhancing its ability to monitor compliance and audit taxpayers. We strongly encourage DoTax to enforce statutory requirements, especially those intended to provide some assurance that the State collects the appropriate amount of taxes, and look forward to seeing improvements in DoTax's process.

We also noted our concern that the required information, i.e., the subcontractors' names and GET license numbers, may be insufficient for DoTax to verify and enforce payment by the subcontractors at the appropriate GET rate. Contractors and subcontractors are not required to provide project-specific information from which DoTax can identify the amounts subcontractors must pay GET at the rate of 4 percent. Subcontractors may work with multiple contractors, may subcontract part or all the work to sub-subcontractors, or may contract directly with an owner. Without project-specific information, DoTax likely is unable to verify compliance without additional information from the contractor and subcontractor. We recommend DoTax require reporting of information necessary for it to trace the revenue exempted by a contractor to ensure the State collects the appropriate amount of tax.

Subsequent to DoTax's comments, the Tax Foundation of Hawai'i published a commentary, "The Pitfalls of the Subcontractor Deduction[8] ," noting the complexity of the exemption and suggesting the Legislature "simplify" the exemption while yielding the same amount of tax revenue. The Tax Foundation offered Guam's gross receipts tax as a model, which requires contractors to pay tax on the total contract amount but exempts subcontractors from tax on amounts received from contractors. While we are unfamiliar with Guam's tax system, we agree that a simpler exemption likely would eliminate some of the concerns we expressed about the lack of project-specific information as well as our disagreement with DoTax's assumptions in its calculation of the tax expenditures associated with the exemption (see page 12). We encourage DoTax to explore and suggest to the Legislature amendments that simplify tax provisions, generally, and, specifically, the contractor-subcontractor exemption.

### Recommendations #6 and #7:

With respect to the exemptions relating to aircraft and aircraft engine leasing, aircraft servicing and maintenance, and construction of an aircraft maintenance facility, we recommended DoTax require taxpayers claiming the exemptions to separately report the amount deducted from GET and that amount exempted from Use Tax. Currently, the GET and Use Tax amounts are reported as a single, consolidated amount on the tax form, making it impossible for DoTax to determine the number of taxpayers deducting revenue under GET or Use Tax and the amount of those claims.

We also believe that requiring taxpayers to separately report exemption amounts that resulted from building a maintenance facility would provide greater transparency about the tax expenditures. More specific data about use of the GET exemption and the Use Tax exemption

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[8] Yamachika, Tom, "The Pitfalls of the Subcontractor Deduction" *Civil Beat*, June 21, 2020, https://www.civilbeat.org/2020/06/tom-yamachika-the-pit-falls-of-the-subcontractor-deduction/

is necessary to meaningfully assess DoTax's administration of the exemptions and for the Legislature to understand how the exemptions are used.

Consistent with its response to our general recommendation that it collect more data, DoTax suggests that other agencies that have "industry expertise" be tasked with that responsibility. Again, that suggestion is well beyond what is necessary to address our recommendation. No industry-specific knowledge is required to collect and consolidate data about taxpayers' use of exemptions. We strongly urge DoTax to capture the information necessary to aid the Legislature's understanding of the exemptions.

We again thank DoTax for their input and assistance on this report.

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GOVERNOR

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June 15, 2020

Mr. Leslie H. Kondo, State Auditor
Office of the Auditor, State of Hawaii
465 South King Street, Room 500
Honolulu, HI 96813

RE: Response to the DRAFT copy of the "Review of General Excise and Use Tax Exemptions and Exclusions" (Report No. 20-02, June 2020)

Dear Mr. Kondo:

Thank you for providing the Department a draft copy of your "Review of General Excise and Use Tax Exemptions and Exclusions" (Report No. 20-09, June 2020). The Department offers the following comments for consideration:

1. **Exhibit 1.1, State Tax Revenues by Type, FY2018 (page 5)** appears to be based on the General Fund tax collections, by type. The title of this chart implies that it is for all State tax collections. If the intent is to illustrate all State tax collections, the following distribution would apply: 43% General Excise, 31% for Individual Income, and 26% for all others.

2. Tax Expenditures: At what "cost"? (page 8) and subsequent tables uses **the term "Tax Expenditures"** in two contexts:
   a. The DOTAX methodology, as explained in our annual "Hawaii General Excise & Use Tax Exemptions" report.
   b. The methodology developed by your office.

   In order to clarify that two different methodologies are being used, we recommend clarifying labels to "DOTAX Tax Expenditure" and "Auditor Tax Expenditure" estimates.

3. **Data source for 2018**. The footnote for the 2016 – 2018 tables indicates that the 2018 DoTax Tax Expenditure data was "based on returns for the filing period as of November 5, 2019." It would be helpful to note that the 2018 data used for the report are different from the "Hawaii General Excise & Use Tax Exemptions, Tax Year 2018" report published by the Department because updated data were provided. This would explain the difference in the 2018 data presented (e.g., Exemption for Reimbursements made to Federal Cost-Plus Contractors infographic & table).

4. **Recommendation #3 (page 43): Require additional data reporting**. Adding additional data reporting requirements regarding the number of jobs and wages to tax returns would add additional burden to taxpayers and the Department. Further, the Department does not share individual taxpayer data.

   In order to provide policy and transparency objectives, the Legislature has been creating "certifying agency" to review and certify exemptions prior to the taxpayer being granted exemptions. This has

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enabled the certifying agency to collect additional information, conduct additional reviews, and provide reporting for transparency.

5. **Recommendation #5 (page 44): Subcontractors**. As indicated in the report, DOTAX is continuing to enhance our ability to improve enforcement of subcontractor exemptions. Beginning July 2020, monthly GE filers will be required to file electronically. As such, the subcontractors will be entered into the electronic return. This will enhance our ability to collect more accurate information to monitor compliance and conduct audits when appropriate.

6. **Recommendation #6 (page 45) and Recommendation #7 (page 46): Separate GE and Use tax reporting**. As indicated in #4, above, in order to provide better oversight of the industries being offered exemptions, it has been helpful to have a certifying agency that has industry expertise and can review policy objectives.

7. **Recommendation #8 (page 46): Federal contractors**. When working with your office on the analysis for this report, we identified a similar inconsistency and are making appropriate modifications.

8. **Recommendation #10 (page 47): Exclusions**. We agree that the lack of information about exclusions makes it difficult for enforcement and analysis. In essence, requiring reporting for exclusions would administratively make them exemptions. This would enhance our ability to collect information about the economy and utilization of the exclusions.

We look forward to working with you on future versions of this report.

Very truly yours,

Rona M. Suzuki, Director
Department of Taxation