DRAFT

[Letter Report to Senate]

The Honorable Donna Mercado Kim, President

And Members of the Senate

State Capitol, Room 409

Honolulu, Hawai‘i 96813

Dear Madam President and Members of the Senate:

[Letter Report to House]

The Honorable Joseph Souki, Speaker of the

House of Representatives and Members of the

House of Representatives

State Capitol, Room 431

Honolulu, Hawai‘i 96813

Dear Mr. Speaker and Members of the House of Representatives:

The State-County Functions Working Group, established by Act 174, Session Laws of Hawai‘i (SLH) 2014, relating to the transient accommodations tax (TAT), is pleased to submit this interim report of Working Group activities in 2014 and its plans for 2015. A final report, which will include the Working Group's findings and recommendations, will be submitted prior to the 2016 Regular Session.

I. State-County Functions Working Group Duties and Responsibilities

The State-County Functions Working Group is comprised of 13 members and administratively placed within the Office of the Auditor. The Working Group is assigned the following responsibilities:

1. Evaluate the division of duties and responsibilities between the State and counties relating to the provision of public services; and
2. Submit a recommendation to the Legislature on the appropriate allocation of the transient accommodations tax revenues between the State and counties that properly reflects the division of duties and responsibilities relating to the provision of public services.

II. Working Group Membership and Meetings

At the Working Group's initial meeting on October 22, 2014, Working Group Chair Simeon Acoba welcomed Working Group members and engaged in preliminary planning for the remainder of 2014 and all of 2015. The members of the Working Group are listed below, along with their appointing authorities:

Working Group Member	**Appointing Authority**
Simeon Acoba, Chair Associate Justice (retired)	Chief Justice
Sananda Baz Budget Director	Mayor, County of Maui
Edward E. Case Senior Vice President and Chief Legal Officer Outrigger Enterprises Group	House Speaker

Mary Alice Evans Deputy Director Department of Business, Economic Development & Tourism	Governor
Steven Hunt Finance Director	Mayor, County of Kaua‘i
George Kam Quiksilver	Senate President
Neal Miyahira Administrator Budget Program Planning and Management Division Department of Budget and Finance	Governor
Deanna Sako Deputy Finance Director	Mayor, County of Hawai‘i
Ray Soon Chief of Staff	Mayor, City and County of Honolulu
Jesse Souki First Deputy to the Chair Department of Land and Natural Resources	Governor
George D. Szigeti President and CEO Hawai‘i Lodging & Tourism Association	House Speaker
Ronald K. Williams President and CEO Atlantis Adventures, LLC	Senate President
Kerry Yoneshige Business Management Officer Department of Accounting and General Services	Governor

Working Group meetings are scheduled for the first Wednesdays in November and December 2014, and in each month throughout 2015, with additional meetings to be scheduled as needed. Each meeting will be duly noticed according to sunshine law

(Chapter 92, Hawai‘i Revised Statutes) requirements. Agendas and minutes, as well as any additional information and resources, will be posted to the Office of the Auditor's website at http://auditor.hawaii.gov/task-forceworking-group/. The Office of the Auditor will provide staff support for the duration of the Working Group.

III. Background on Hawai‘i's Transient Accommodations Tax

Initially established in 1986,[1] the TAT took effect on January 1, 1987, and levied a 5 percent tax on the *gross income* or *gross proceeds* derived from furnishing transient accommodations.[2] The Legislature sought to tax the tourism industry for the benefit of the state, while at the same time minimizing the impact of the tax on the industry by excluding general excise taxes collected from calculation of "*gross income*" or "*gross proceeds*".

a. Transient Accommodations Tax Rate

The TAT tax rate has increased over time. In 1993,[3] the Legislature changed the TAT rate from 5 percent to 6 percent beginning July 1, 1994. Five years later, in 1998,[4] the rate was increased to 7.25 percent beginning January 1, 1999. The act also assessed on occupants of resort time share vacation units a 7.25 percent tax on the fair market rental value of those units.

[1] Act 340 (SLH 1986).
[2] As defined in Act 340 (SLH 1986), *transient accommodations* means the furnishing of a room, apartment, suite, or the like which is customarily occupied by a transient for less than 180 consecutive days for each letting by a hotel, apartment hotel, motel, horizontal property regime, or apartment as defined in Chapter 514A, Hawai‘i Revised Statutes, cooperative apartment, rooming house, or other place in which lodgings are regularly furnished to transients for consideration.
[3] Act 7, Special Session Laws of Hawai‘i (SSLH) 1993.
[4] Act 156 (SLH 1998).

Finally, Act 61 (SLH 2009) increased the rate from 7.25 percent to 8.25 percent for the period beginning July 1, 2009 to June 30, 2010; and to 9.25 percent for the period July 1, 2010 to June 30, 2015. The rate had been scheduled to revert to 7.25 percent on July 1, 2015,[5] but Act 161 (SLH 2013) made permanent the 9.25 percent rate which had been in effect since July 1, 2010. The effective dates and changes in TAT rates are shown in Exhibit 1.

Exhibit 1
TAT Rate Changes and Effective Dates, Inception – Current

Effective Date	Rate
January 1987	5 %
July 1994	6 %
January 1999	7.25 %
July 2009	8.25 %
July 2010	9.25 %

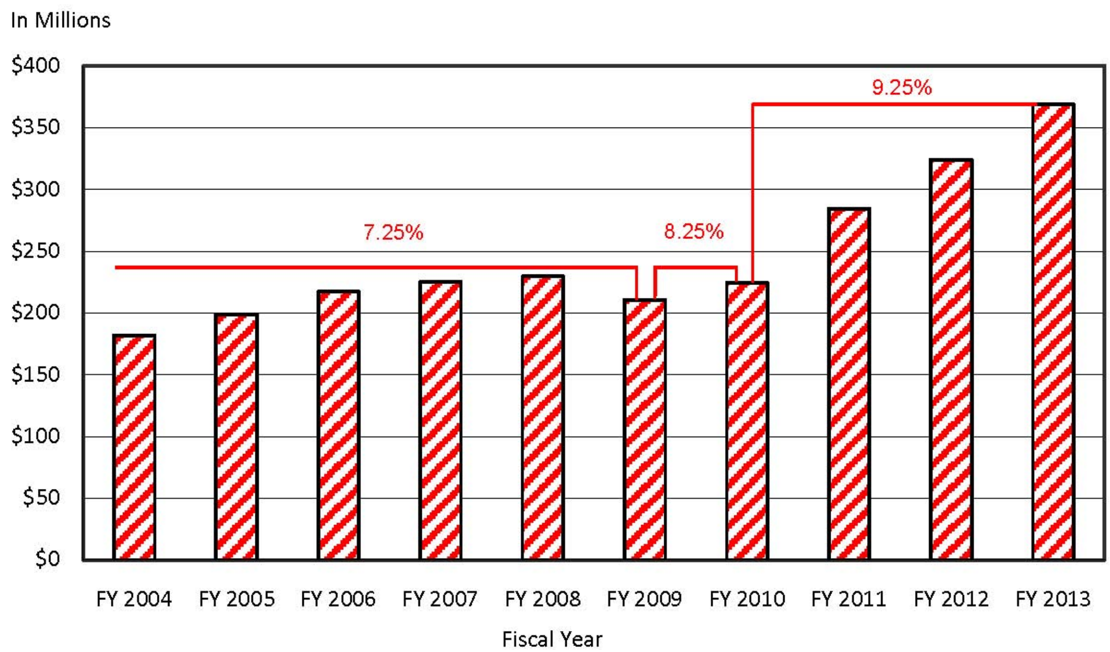
Source: Office of the Auditor

Exhibit 2 shows the collections and rates of the TAT for FY2004–FY2013.

Exhibit 2
TAT Collections and Rates, FY2004–FY2013

[5] Act 161 (SLH 2013).

DRAFT



Source: Hawai‘i Department of Taxation, Annual Report 2012-2013 and Office of the Auditor

b. Transient Accommodations Tax Distribution

Although the TAT took effect in 1987, it was not until 1990 that a portion of the TAT collected was distributed to the counties. Thereafter, the distribution rate changed more than a dozen times over the next two decades.

Act 185 (SLH 1990) began distributing TAT funds to the State and various counties as follows:

- 5 percent of the revenues collected were retained by the State for TAT-related administrative purposes;
- Of the remaining 95 percent of TAT collected:
    - 14.5 percent was to be distributed to Kaua‘i County;

- o 18.6 percent was to be distributed to Hawai‘i County;
- o 22.8 percent was to be distributed to Maui County; and
- o 44.1 percent was to be distributed to the City and County of Honolulu.

In 1993[6] the distribution was changed beginning July 1994, by increasing the State's portion for deposits to the Convention Center Capital and Operations Special Fund[7]. Distribution to the counties remained the same as in 1990; thus:

- 5 percent of the revenues collected was retained by the State for TAT-related administrative purposes;
- One-sixth (1/6) of the revenues collected was deposited into the Convention Center Capital and Operations Special Fund; and
- The remaining TAT collected was distributed to the counties in the same proportional share as in prior years.

The 1998 Legislature[8] amended the TAT by assessing and collecting taxes on resort time share vacation units. Additionally, the measure increased distribution to the Convention Center Capital Special Fund, included distribution to the Tourism Special Fund, and divided the remaining TAT collected among the counties so that:

- 17.3 percent of the revenues collected was deposited into the Convention Center Capital Special Fund;
- 37.9 percent was deposited into the Tourism Special Fund; and

[6] Act 7 (SSLH 1993).
[7] The Legislature later changed the Convention Center Capital and Operations Special Fund to the Convention Center Capital Special Fund through Act 124 (SLH 1997).
[8] Act 156 (SLH 1998).

- 44.8 percent was distributed to the counties in the same proportional share as in prior years.

In 2002,[9] the Legislature for the first time limited TAT distributions to the Tourism Special Fund (capped at almost $62.3 million, and lowered the percentage deposited to the fund from 37.9 percent to 32.6 percent, effective July 2002), and to the Convention Center Enterprise Special Fund (capped at $31 million, with any excess revenues deposited into the general fund, effective January 2002).[10] If the deposit to the tourism fund exceeded its cap, then of the remaining overage, $1 million would be deposited in the following proportional shares—90 percent to the State Parks Special Fund and 10 percent to the Statewide Trail and Access Program—but not more than $1 million in any fiscal year. Finally, the Legislature deposited 5.3 percent into the newly established Transient Accommodations Tax Trust Fund.[11]

Over the next few years—2005 to 2008—the Legislature continued adjusting TAT revenue distribution by removing caps,[12] increasing and changing distribution,[13] and establishing and funding new funds.[14]

[9] Act 250 (SLH 2002).
[10] Act 253 (SLH 2002).
[11] The Legislature later repealed the Transient Accommodations Tax Trust Fund through Act 235 (SLH 2005).
[12] Act 235 (SLH 2005) removed the cap and increased the allocation of TAT revenues to the Tourism Special Fund; repealed the Transient Accommodations Tax Trust Fund; revised the allocation of TAT revenue for the State Parks Special Fund and the Special Land Development Fund; and directed excess revenues to be deposited into the general fund.
[13] Act 209 (SLH 2006) increased the ceiling of TAT revenues deposited into the Convention Center Enterprise Special Fund and directed excess revenues to be deposited into the general fund.
[14] Act 201 (SLH 2007) established and funded the Tourism Emergency Trust Fund.

In 2009, the Legislature began exploring different avenues for increasing revenues to replace record shortfalls in the State budget, due to what was later called the Great Recession. Initially vetoed by the Governor, the TAT bill[15] veto was overridden by the Legislature and later enacted as Act 61 (SLH 2009); it increased the TAT and required that the additional revenues collected be deposited to the general fund. Thus, the 2009 TAT rate of 7.25 percent was increased to 8.25 percent from July 2009 to June 2010; and to 9.25 percent from July 2010 to June 2015.

In 2011, the Legislature continued to address budget shortfalls by increasing state revenues from the TAT. To accomplish this, the Legislature passed a measure that limited TAT revenues deposited into the Tourism Special Fund to no more than $69 million, and capped TAT revenues to the counties at $93 million.[16] In its Conference Committee Report,[17] the Legislature stated that the measure was intended to temporarily increase and preserve the amount of state revenues derived from the TAT, calling it a necessary component of the package of legislation aimed at addressing the State's extended economic crisis.

By 2012, the State's focus returned to growing travel and tourism. Leveraging an executive order by President Obama in January 2012 that announced new initiatives to significantly increase travel and tourism in the United States, the Legislature sought to

[15]Act 61, (SLH 2009).
[16] Act 103 (SLH 2011).
[17] Conference Committee Report No. 139 on Senate Bill 1186, Senate Draft 2, House Draft 1, Conference Draft 1, dated April 29, 2011.

DRAFT

grow TAT deposits in the Tourism Special Fund to $71 million (from $69 million) to take advantage of the easing of access to Hawai‘i for international visitors.[18]

In 2013, the Legislature made permanent the 9.25 percent TAT rate and the caps on TAT distribution to the Tourism Special Fund and the counties.[19] Versions of the measure—for example, Senate Bill 1194, Senate Draft 2, proposed House Draft 1—were hotly debated among stakeholders in legislative committees.

The State Director of Finance testified that reducing the 9.25 percent TAT charge to 7.25 percent repeals an important revenue source for fiscal years 2014 and 2015. Hawai‘i Lodging and Tourism Association and Hawai‘i Tourism Authority representatives advocated a reduction of the TAT to 7.25 percent as a means of keeping Hawai‘i’s visitor industry competitive and maintaining the positive momentum of the industry and long-term positioning of the Hawaiian Islands in the world-wide market. The counties—the City and County of Honolulu and the counties of Hawai‘i, Maui, and Kaua‘i—espoused the need for the TAT to support services for residents and visitors alike, including ocean safety, park maintenance, police protection, fire protection, bus services, and infrastructure repair and maintenance. For some counties, TAT distributions are the second largest source of county revenue, making it important that the distributions increase as visitor counts increase.

[18] Act 171 (SLH 2012).
[19] Act 161 (SLH 2013).

DRAFT

The Legislature ultimately decided that allowing the TAT rate to revert to 7.25 percent would deprive the general fund of needed tax revenues. Retention of the 9.25 percent tax rate was seen as key to ensuring that the State's general fund remains balanced beyond the fiscal biennium 2013–2015.[20] The 9.25 percent cap was made permanent, and the distribution of revenue was set as follows:

- $33 million is allocated to the Convention Center Enterprise Special Fund (rather than 17.3 percent);
- $82 million is allocated to the Tourism Special Fund (rather than 34.2 percent), $1 million of which is allocated to operate a Hawaiian center and the Museum of Hawaiian Music and Dance at the Hawai'i Convention Center;
- The $1 million allocation to the State Parks Special Fund and Special Land Development Fund is repealed;
- $93 million is allocated to the counties (rather than 44.8 percent) and the $93 million cap is repealed; and
- $3 million of the excess TAT revenues is deposited into the general fund for natural resources important to the visitor industry, facilities, and public lands connected with enhancing the visitor experience, to be expended by mutual agreement of the Board of Land and Natural Resources and the Board of Directors of the Hawai'i Tourism Authority[21].

[20] Conference Committee Report No. 146 on Senate Bill 1194, Senate Draft 2, House Draft 1, Conference Draft 1, dated April 26, 2013.
[21] Pending language from Department of Land and Natural Resources.

The Legislature also added in 2013 the required use of a portion of the TAT revenues to supplement deficient county public employer contribution amounts commencing with FY2019.[22] Recognizing the need to reduce the unfunded liability of the State's Employer-Union Health Benefits Trust Fund, the Legislature directed the use of general excise tax and TAT revenues to supplement deficit payments by state and county public employers, respectively.

Finally, in 2014 the Legislature again changed TAT allocations to the counties and established the State-County Functions Working Group to evaluate the division of duties and responsibilities between the State and counties and recommend the appropriate TAT allocations to the counties.[23] One legislative committee noted that TAT had been the subject of considerable discussion and debate among policymakers regarding its effect as a significant revenue generator and funding source in the State.[24]

Stakeholder testimonies alluded to myriad impacts if the cap were lifted or retained, citing general fund tax losses if the cap was removed;[25] that county annual tourism-related expenditures far exceed the county's capped portion of the TAT;[26] and that the imposed cap was always understood to be a temporary measure;[27] among others. In conference, the Legislature raised the TAT revenues allocated to the counties to $103

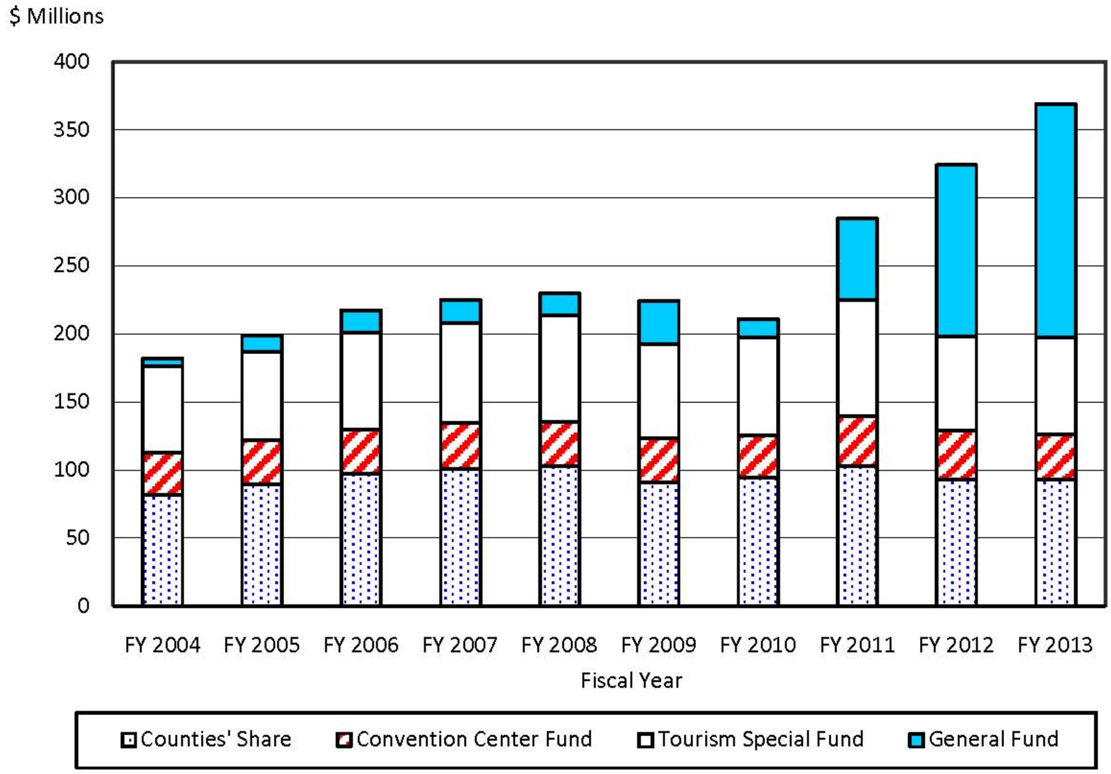
[22] Act 268 (SLH 2013).
[23] Act 174 (SLH 2014).
[24] House Committee on Finance, Standing Committee Report No. 764-14 on House Bill 1671, House Draft 1, dated February 28, 2014.
[25] Testimony by Kalbert Young, State Director of Finance, dated March 28, 2014, to the Senate Committee on Ways and Means on House Bill No. 1671, House Draft 1, Senate Draft 1.
[26] Testimony of Kirk Caldwell, Mayor of the City and County of Honolulu, dated March 28, 2014, to the Senate Committee on Ways and Means on House Bill No. 1671, House Draft 1, Senate Draft 1.
[27] Testimony of William P. Kenoi, Mayor of the County of Hawaiʻi, dated March 28, 2014, to the Senate Committee on Ways and Means on House Bill No. 1671, House Draft 1, Senate Draft 1.

million for fiscal years 2015 and 2016, but reduced the allocation to $93 million thereafter. Before the Legislature considered permanently establishing the TAT revenue allocations between the State and counties, it established and directed this State-County Functions Working Group to conduct a study to determine the appropriate division of duties and responsibilities to provide public services, and submit an interim and final report to the 2015 and 2016 Legislatures, respectively.

Exhibit 3 shows TAT distributions to the various funds—counties' share, Convention Center Enterprise Special Fund, Tourism Special Fund, and the general fund—from FY2004 through FY2013.

Exhibit 3
TAT Distributions, FY2004–FY2013

DRAFT



Source: Hawai'i Department of Taxation, Annual Report 2012-2013

IV. Working Group Study Approach and Timetable

At the State-County Functions Working Group's November 5, 2014, meeting, the Working Group considered its approach to evaluating generally the division of duties and responsibilities among the State and counties relating to public services, as required by Act 174. Among the topics and issues discussed were:

- the relevant legislative history and acts relating to the transient accommodations tax;
- the definition of *public services* referred to in Act 174 and possible ways of measuring this;

- the division of public services as articulated in the Constitution of the State of Hawai‘i and the Revised Charter of Honolulu and Maui County, Kaua‘i County, and Hawai‘i County Charters;
- evaluation of the division of public services between the State and the counties, as related above with respect to tourism;
- different formulas, standards, and guidelines for the above issues ;
- the desirability of rationality and objectivity in any formula, standard, and guideline;
- the purpose of the TAT allocation as a revenue sharing device or a method of reimbursing the counties for expenditures related to tourism; and
- working towards consensus.

Although Working Group members bring unique expertise and perspectives to the table—including from State, county, and private sectors—the Working Group favored engaging the services of a consultant to assist with compilation of references and resources, data analysis, and final report development, among other possible tasks. Upon discussion, the Working Group determined to engage such a consultant and to develop specifications for a request for proposals (RFP) at subsequent Working Group meetings.

A request will be made to the 2015 Legislature in the Auditor’s section of the legislative budget bill for an appropriation of $150,000 to be used to engage a consultant to assist the Working Group. Any portion of the appropriation not used for this purpose will lapse

DRAFT

to the general fund. Although the consultant may assist with developing and compiling the final report, Working Group members felt at this point that the conclusions and recommendations would come from the Working Group, not the consultant.

Delivery of the Working Group's final report to the 2016 Legislature will be by the required deadline of 20 days prior to the convening of the 2016 Legislature. That report will summarize the discussions of the Working Group, as well as make findings and recommendations. Draft legislation may be suggested for the 2016 Legislative Session. Part of the Working Group's role through the 2016 Regular Session may be to explain such legislation by the Legislature's committees by way of presentations and testimony. As directed by Act 174 (SLH 2014), the Working Group will cease to exist upon *sine die* of the 2016 Regular Session.

Should you have any questions, please do not hesitate to contact me or Ms. Jan K. Yamane, Acting State Auditor.

Respectfully submitted,

Simeon Acoba

Chair

State-County Functions Working Group

DRAFT

[Letter Report to Senate]

[Letter Report to House]

OUTLINE

I. State-County Functions Working Group (TAT) Duties and Responsibilities

II. Working Group Membership and Meetings

III. Background on Hawai‘i's Transient Accommodations Tax

a. Transient Accommodations Tax Rate

Exhibit 1
TAT Rate Changes and Effective Dates, Inception – Current

Exhibit 2
TAT Collections and Rates, FY2004–FY2013

b. Transient Accommodations Tax Distribution

Exhibit 3
TAT Distributions, FY2004–FY2013

IV. Working Group Study Approach and Timetable

DRAFT