REPORT OF THE 2001-2003 TAX REVIEW COMMISSION

THE 2001 – 2003 TAX REVIEW COMMISSION

Craig K. Hirai
Chair
Member, Torkildson, Katz, Fonseca, Moore & Hetherington,
Attorneys at Law, A Law Corporation

Leighton H.C. Wong
Vice Chair
Attorney at Law

George Freitas
Retired State of Hawaii Director of Taxation

Marilyn J. Gagen
Retired Partner
Deloitte & Touche LLP

James E.T. Moncur
Professor of Economics
University of Hawaii at Manoa

Marilyn M. Niwao
President, Niwao & Roberts, Certified Public Accountants,
A Professional Corporation

Cyrus I. Oda
Area Director of Finance
Sheraton Hotels of Waikiki

Commission Staff

Kevin T. Wakayama
Commission Consultant
Consultant to the State of Hawaii Department of Taxation

TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

REPORT OF THE

2001 - 2003 TAX REVIEW COMMISSION

I. FRAMEWORK

A. Duty

At the direction of the people of Hawaii, through the Constitutional Convention of 1978, the Tax Review Commission ("Commission") is charged with the duty to "submit to the legislature an evaluation of the State's tax structure, recommend revenue and tax policy and then dissolve." State Constitution, Article VII, Section 3. The statute implementing the Commission provides that the Commission "shall conduct a systematic review of the State's tax structure, using such standards as equity and efficiency."[1]

B. Principles of Sound Tax Policy

In the area of state taxation, the National Conference of State Legislatures ("NCSL") has provided the best set of principles for sound tax policy. In 1988, the NCSL gathered a group of lawmakers and academics to discuss improving state tax systems. The principles of sound tax policy articulated by these tax theorists and policymakers were outlined in the seminal report: "Principles of a High-Quality State Revenue System," which has been widely circulated by the NCSL. The report appears in <u>The Unfinished Agenda for State Tax Reform</u> (Gold 1988) and is discussed in Brunori, <u>State Tax Policy, A Political Perspective</u>, The Urban Institute Press (2001). The five major principles of sound tax policy, as described by Brunori, are set forth below.

- Principle One: *Provision of Appropriate Revenues*.

Brunori, states that "The primary purpose of any tax system is to raise (adequate) revenue to cover the costs of public expenditures."[2] He goes on to state that "A tax system must not only provide for current spending, but also meet the future revenue needs of the state."[3] The NCSL report states that "To meet the revenue needs of a state, a tax system must demonstrate sufficiency, stability and certainty."[4] Brunori goes on to state that:

> "*Sufficiency* requires that enough revenue be available to balance the state budget and to adapt that budget to changes in state spending."[5] "The hallmark of sufficiency is that the state tax systems maintain flexibility. Spending needs will vary over time as political and economic developments unfold."[6]
>
> "*Stability* requires that a consistent amount of revenue be collected over time, necessitating a mix of taxes, 'with some responding less sharply to economic change'[7] than others."[8]
>
> "*Certainty* requires that policy makers keep the number and types of tax changes to a minimum."[9] "The 1992 NCSL report recognized that frequent changes interfere with economic choices and with long-term financial planning for both businesses and

individuals."[10] Frequent changes ultimately decrease net revenue because they create confusion, decrease voluntary payment of taxes, and increase administrative and enforcement cost. "Of course, all governments must recognize that in certain instances the revenue system must be altered to meet the needs of a changing economy or to improve fairness and efficiency. But most would agree that significant changes to state revenue systems should be implemented cautiously and with much forethought."[11]

- Principle Two: *Neutrality.*

Neutrality according to Brunori requires "that taxes have as little effect on market decisions as possible"[12]. Market conditions and economic efficiency - not the tax code - should dictate business decisions. Similarly, taxes should not be used to influence individual consumption choices. To be sure, all taxes affect decision making to some extent. Optimally, however, the tax system should minimize market distortions.[13] Policy makers widely agree that tax neutrality is best attained by a system with a broad tax base (i.e. one that has few exemptions, deductions, and credits) and low rates (NCSL, 1992).[14]

- Principle Three: *Equity.*

According to Brunori, "Tax systems…should be fair and equitable. But the way to achieve equity through policy choices…is subject to substantial disagreement. After all, "equity" is a concept fraught with value judgments, and fairness and justice are inherently difficult ideals upon which to build consensus."[15] The fairness of a tax system is measured by its horizontal and vertical equity.

> *Horizontal* equity means that "similarly situated taxpayers should be treated the same".[16] Said a different way; taxpayers with the same income or the same consumption should bear the same tax burden. "This concept is closely related to the issue of neutrality discussed earlier. But while neutrality primarily concerns economic efficiency, horizontal equity – that people and firms should be treated equally - is seen as imperative in a democratic society."[17] In America, it is a fundamental principle that all persons should be treated equally. "Real or perceived differences in taxation of equals undermine public confidence in a tax system."[18] Inequality breeds distrust of the tax system and of the government, decreases voluntary payment of taxes, and increases administration and enforcement costs. Exemptions and credits that favor the few and undermine equality do not give rise to political unrest if there is consensus that the favored group (e.g., veterans) deserves the preference.[19] If there is no consensus, as in the case of business incentive tax credits that are lobbied for the favored few at the expense of the many, there can be widespread public dissatisfaction. Especially if those not enjoying the benefit of the credits must pay higher taxes to make up the revenue shortfall.
>
> *Vertical* equity means that taxpayers in unequal circumstances should be taxed on the basis of their ability to pay. Income is the most commonly used measure of ability to pay. A tax system is said to be "progressive" when the tax burden varies directly with income (borne to a greater extent by higher income taxpayers), "regressive" when the burden is inversely related to income (disproportionately borne by lower income taxpayers), and "proportional" when there is no change in burden as income changes.

> Progressive tax systems are based on ability to pay and therefore are vertically equitable. Regressive tax systems are not based on ability to pay and therefore should be avoided in a sound revenue system.

The equity of a tax system should be evaluated by examining the whole system. For example; consumption taxes, such as the Hawaii General Excise Tax ("GET") is generally thought of as regressive in nature, and therefore not equitable. However, the personal income tax, which is more progressive in nature, helps to offset some of the regressivity of the GET. Because of the substantial amount of revenue raised by the GET compared to the personal income tax, this offset may or may not be sufficient to achieve the goal of equity.

- Principle Four: *Easy and Economical to Administer*.

Sound tax policy requires that the costs of compliance for taxpayers and the costs of collection for the government be minimized. An efficient revenue system avoids complex provisions and regulations, multiple filing and reporting requirements, and numerous deductions, exclusions, exemptions, and credits. The goal of simplicity is related to the goal of neutrality because the factors that lead to complexity inevitably distort market decisions.[20]

A complicated tax system creates doubt as to the meaning of the law, and decreases voluntary payment of taxes. Complexity decreases certainty of tax laws, decreases the certainty of revenues, impairs revenue forecasting, and deters effective fiscal planning. A simple tax system increases public understanding of the law, increases public confidence in the tax system and in the government, and increases voluntary payment of taxes and therefore revenues.[21]

"The goal of simplicity requires constant vigilance. Political pressure to alleviate burdens on the poor creates numerous (GET) and personal income tax exemptions. Political pressure to spur economic development creates numerous exemptions, deductions, and credits for virtually all taxes paid by businesses. The more the state governments create tax breaks…the more they complicate the system. The breaks for individuals or business entities increase the costs of compliance with, and the administration of, the tax laws."[22]

- Principle Five: *Accountability.*

Accountability must occur on three levels in order to ensure the integrity of the tax system. Taxpayers must be held accountable to pay their taxes. The Tax Department must be held accountable to administer and enforce the tax laws efficiently and fairly. The legislature must be held accountable for the integrity of the tax laws. Government must demonstrate the means and the political will to ensure that taxpayers pay their taxes. Lax tax enforcement leads to widespread tax evasion.[23]

Legislative accountability begins with open, transparent tax policy. Tax decisions should be made openly, and the laws governing taxes should be explicit rather than hidden. The costs and benefits of fiscal decisions, especially those that favor particular taxpayers, should be understood by the electorate as well as by tax administrators. Legislative accountability also means evaluating tax incentives with the same care as a legislative appropriation, thoroughly researching the cost/benefit, and approving the incentive only if there is a substantial public benefit. Sound tax policy avoids political favoritism.

Accountability requires states to review existing laws and determine whether they are continuing to serve the state's and citizen's needs. The reason that most states fail to evaluate their revenue laws regularly is that they are not legally required to do so.[24] The Tax Review Commission is one method for achieving this periodic review and evaluation. However, since the legislature is not bound to follow the recommendations of the Commission, the ability to achieve accountability is voluntary.

C. Implementing Sound Tax Policy

In Leadership Lessons, Hawaii Business, August 2002, p.23, former Governor George Ariyoshi, who was generally considered a fiscal conservative, discusses what is needed to create a sustainable future for Hawaii.

> "Principle is rediscovered and put back to work by asking, 'What is good for the long term?' Land and water are obviously limited resources, and the costs of developing communities are not one-time but ongoing. All of society has a stake in orderly, incremental development, not just the developer of a new project and its residents. In this light, government should make hard decisions, and the private sector should do what it does best – generate capital, organize expertise and labor, and provide competitively priced housing.
>
> Drawing such a traditional line is not a matter of being pro-business. In fact, as governor, I was occasionally accused of being anti-business. I opposed the seemingly endless proposals for special tax credits, which in recent years have come to be regarded in many circles as smart government. In practice, tax credits create an uneven playing field. The recent dispute over a massive tax credit for an aquarium attraction is an obvious example. Why should society grant an enormous tax credit favoring one development, one region, or one island?
>
> Even tax credits that attempt to promote a broad concept have a way of favoring some interests over others. For example, tax credits for hotel renovation effectively favor those hotels that need renovating. Hotels that have diligently maintained themselves are penalized in the competition of the market place.
>
> Generally, it has been my experience that the solid investor needs stability, not favoritism. In this light, a level playing field, treating all businesses equally, should be a fundamental public strategy for pursuing economic growth, Government's obligation is to maintain the health of its tax base to fulfill its most essential responsibilities. In our evolving vocabulary, sound government should be equated with sustainable government. Sound government should be based on a long-term balance of revenue and expenditure."

According to Brunori, tax experts widely agree on what constitutes sound tax policy. But devising policies and government practices that adhere to these principles is much more difficult. Political and economic pressures can lead to laws and regulations that often conflict with the principles described here. Tax breaks for particular individuals or businesses, often made in the name of fairness or economic development, usually lead to less equitable, less neutral, and more costly tax systems.[25] Yet he believes that, the goals set forth in the principles are worth striving toward. He states that "It may be difficult to create a fair and efficient tax system, but the difficulty alone should not be a deterrent. Good government requires sound tax policy; it is incumbent upon our political leaders to pursue that ideal."[26]

In our review of the Hawaii tax system, we attempted to keep these principles in mind. Our recommendations are made after reviewing and evaluating the present tax system in light of these goals of sound tax policy.

II. RECOMMENDATIONS AND ANALYSIS

Keeping the above measures of sound tax policy in mind, the Commission reviewed, discussed, and commissioned studies to evaluate the Hawaii tax system and make recommendations in areas where change would increase the goal of achieving sound tax policy. These recommendations are discussed below under the following general topics:

Streamlined Sales Tax Project

Business Incentive Tax Credits

General Excise Tax

Taxation of Nonprofit Organizations

Net Income Tax

Taxation of Retirement Income

Estate and Transfer Tax

Department of Taxation Operations

Revenue Sufficiency for Future Needs

Enhancement of Research and Modeling Capabilities

Other Considerations

A. Streamlined Sales Tax Project

Dr. William Fox suggests that Hawaii enact legislation allowing the State to join the Streamlined Sales Tax ("SST") Project.[27] Legislation enabling states to participate in this uniform sales tax project has been adopted by over 30 states as of June, 2002. The SST Project aims to provide certainty and to eliminate duplicated interstate taxation by providing uniform definitions of taxable items, transactions, and activities, and by providing uniform procedures. Under the SST Project, an interstate vendor should be assured that: (1) "delivery" or "passage of title" or "condiment" means the same thing in Hawaii as in the other signatory states, and (2) the vendor will not be double taxed by two states for the same transaction.

Hawaii would potentially achieve not only the benefit of better definitions, uniformity, and certainty, but also increased tax compliance by interstate vendors (primarily mail order and e-commerce merchants) who will be required to agree to pay state taxes under the SST Project. In addition, because of Hawaii's uniquely broad based General Excise and Use Tax system, by joining the SST Project, Hawaii may be able to better maintain the viability of its broad revenue base.

On November 12, 2002, thirty three states and the District of Columbia voted to approve the SST Project's Streamlined Sales and Use Tax Agreement (the "SST Agreement"). Hawaii will want to examine the provisions of the SST Agreement very carefully, to determine how legislation authorizing the State to join the SST Project can tie the operation of the Hawaii General Excise and Use Tax laws into the new sales and use tax system being proposed under the SST Agreement.

The Commission recommends that the Legislature strongly encourage the Hawaii Congressional delegation to support federal legislation defining a new nexus standard that would allow the states to more effectively and efficiently collect use taxes from interstate vendors.[28]

B. Business Incentive Tax Credits.

1. Overhaul of the Business Incentive Tax Credit Process.

The Commission believes that the State must make a commitment to require accountability for any business tax incentives. The State must insure that the targeted tax incentive goes through a legislative process where there is accountability for the tax benefit both at the legislature and through enforcement by the Tax Department or some other agency. This will insure that (a) the true costs and benefits of the tax incentive are understood by everyone, and (b) that the benefit being provided to the State is commensurate to the cost to the State. The fact that there may be less legislative, media, and public scrutiny of how tax credit dollars are spent does not make tax credit dollars any less valuable than general fund dollars.

In order to promote consistent evaluation of the merits of business tax incentives, the Commission recommends that uniform decision-making procedures be implemented based on the following requirements:[29]

(i) *Cost-benefit studies*. Cost-benefit studies should be required prior to inaugurating new or revised tax credit programs. Policy makers should use only those programs with quantifiable and demonstrable benefits over costs. Such costs and benefits should not only look at fiscal and economic effects, but should examine social ones as well.

(ii) *Periodic evaluations* of all tax incentive programs should be required.

(iii) *Truth and disclosure reporting* separate and apart from a taxpayer's tax returns should generally be required of all taxpayers benefiting from tax incentive programs, making public all aspects of these subsidies for private investment.

(iv) *Strategic planning*. Embed tax incentives in strategic plans, leveraging as much of the State's scarce resources as possible. Rather than promoting diverse incentives in search of a cohesive strategy, the State should employ only incentives that make strategic sense.

(v) *Public participation*. Encourage public participation in and comment on tax incentive use to foster public accountability. There should at least be as much public discussion over generous multi-million dollar business incentive tax credits as there is over $50,000 renovations to school libraries.

(vi) *Sunset provisions* should be required to ensure that the above processes will be implemented before an incentive can be extended. It should be demonstrated to the Legislature that the targeted benefit to the State was in fact received, what the tax cost of that benefit was, and whether the continuation of the tax incentive is appropriate and necessary.

(vii) *Enforcement*. Given the magnitude and the complexity of these business incentive tax credits, the small chance of audit, ambiguous statutory requirements as to what can be claimed as a credit, there must be legislative oversight of these credits. In addition, the Department of Taxation must be given sufficient resources to police these credits.

2. Background.

The Commission believes that the State's tax structure could be severely compromised by recently enacted business incentive tax credits if they are not subjected to reasonable limits and mechanisms for accountability. Prior to the last Tax Review Commission Report in 1996, business incentive tax credits were few in numbers, narrowly focused and limited in amount. The revenue impact of these credits was small and certain. Since that time, business incentive tax credits have doubled in number, are available for general business activities, and often have no practical limits. Some incentives provide a tax credit of 200% or more of the investment by the taxpayer. Some incentives provide that credits can be allocated among partners without regard to the economic substance provisions of the federal Internal Revenue Code. Ignoring economic substance and giving overly generous amounts of the incentives may lead to substantial abuse. On July 10, 2002, the Council on Revenues announced an unexpected $109 million or 3.5% shortfall in revenues for the fiscal year ending June 30, 2002, compared with the previous fiscal year. Council vice-chairman Paul Brewbaker stated that "If you're going into the tax code every year and changing a half-dozen different things without a good idea of what the revenue implications are, it shouldn't be that much of a surprise when the revenue doesn't show up.'[30] The recent proliferation of business incentive tax credits without accountability has caused uncertainty in revenue forecasting, and may be a major cause of present and future revenue shortfalls.

The Tax Foundation of Hawaii, a nonprofit organization dedicated to the equitable taxation of businesses in Hawaii, has been openly critical of the business incentive tax credits.

> "In recent years, lawmakers have spawned a spate of income tax credits designed to modify human behavior. Disguised as economic development incentives, these credits have no bearing or relationship to the tax burden imposed and therefore amount to

nothing more than a subsidy of certain industries or activities. The ultimate result is to shift the burden or taxes from those favored with such tax credits to those not so favored. As a result, the base of in income tax is eroded by such special interest tax credits at the expense of all taxpayers who must continue to pay the high burden of taxes. Thus, lawmakers have been precluded from doing what needs to be done to expand the economic base of the state and that is to improve the investment and business climate of the state. The improvement of the investment and business climate is critical to attracting new capital to the state to create jobs needed by Hawaii's people. We believe the Commission should review and evaluate the current spate of income tax credits and establish criteria against which these credits and all future proposals for income tax credits should be measured with respect to appropriateness to alleviating the tax burden imposed."[31]

3. Accountability.

From 1957 to 1969, Hawaii had only three very progressive consumer tax credits (for (1) taxes paid out-of-state, (2) education, and (3) a consumer credit to offset the 4% general excise tax). Today, there are 20 tax credits. Six of them are progressive consumer tax credits with low fiscal impact ((1) taxes paid out-of-state, (2) rent, (3) residential energy device, (4) dependent care, (5) car seat, and (6) low income). Thirteen of them are targeted business tax incentives ((1) ethanol production facility, (2) high technology, (3) research activity, (4) low income housing refundable, (5) motion picture, (6) hotel remodeling, (7) commercial energy device, (8) nursing facilities, (9) job rehabilitation, (10) low income housing, (11) enterprise zone, (12) fishing fuel, and (13) home remodeling credit). Of the thirteen targeted tax incentives, seven were passed in the last five years.

Targeted tax incentives are generally only demonstrably good for those relatively few taxpayers that qualify for the benefits, and may not be demonstrably good for anyone else. They are not supported by rules of sound tax policy. In the first instance, they decrease State revenue and add complexity to the tax system. They may also be unfair to other businesses. Almost all of the present incentives lack accountability, and therefore create something of a "black hole" in State fiscal responsibility.[32] A targeted tax incentive does not appropriate hard earned and increasingly scarce revenues. Rather, it creates a tax benefit of unknown proportions against future revenues, before the revenues are collected and subjected to the legislative appropriation process.

Appropriations to favored businesses, or subsidies, are rarely enacted. Every public appropriation is publicly scrutinized. A tax incentive is a potential "black hole", because it is a future benefit of unknown proportions, which is determined by the favored taxpayer's interpretation of what the tax credit should be, and is claimed on a tax return which is confidential.

The tax system is geared to efficiently collect taxes through (1) voluntary compliance of taxpayers, and (2) enforcement, principally in the form of public education. Audit is a very labor-intensive form of enforcement. Less than 2% of all taxpayers are audited. Tax incentives may effectively give money away through a tax collection system that is not particularly well equipped to enforce compliance with these laws.

To demonstrate a part of the accountability and compliance issues involved with business incentive tax credits one need only to look at Schedule CR on which business tax credits are taken. 20 different credits are listed on the first page. To take the high tech credit, the taxpayer simply inserts a number in the high tech credit box. It is then left up to the Department of Taxation to determine whether the taxpayer is audited. If the taxpayer is audited, the State auditor must then determine whether the taxpayer correctly determined the credit. Consumer credits, like the child car seat credit, are fairly simple to confirm. Business incentive tax credits, on the other hand, can be somewhat difficult and time consuming to audit. The auditor must fully investigate the nature and scope of the business to determine whether the business is qualified for the credit and then determine what the eligible costs are. The present guidelines for the auditor to determine the nature and scope of what could be a $1,000,000 credit may be a few somewhat ambiguous words and phrases in a statute.

4. Examples.

The Commission provides the following as examples of why review of business incentive tax credits is necessary:

a. Ethanol Production Facility Credit.

The ethanol production facility tax credit, passed in 2000, illustrates some of these problems. First, it is potentially a 240% refundable tax credit for the amount of "investment" in an ethanol production facility. For example, if a taxpayer invests $10 million in a 10,000,000 gallon ethanol production facility, the annual income tax credit under the statute is the lesser of 30% of the investment or $3 million per year for eight years, or a total credit of $24 million. In a world where a 10% credit is considered generous, this 240% credit might be considered unusually large. Second, there could be a question as to whether the term "investment" includes just the ethanol plant itself, or pre-production or post-production storage facilities, administrative facilities, sales and marketing facilities, site preparation costs, administrative overhead, federal indirect costs, as well. "Investment" is defined in the statute as "a nonrefundable expenditure directly related to the construction of any qualifying ethanol production facility, exclusive of land costs."[33] The taxpayer and the Department of Taxation must rely on this 18-word phrase to determine what is reasonable for what could be a $24 million tax credit for an investment of $10 million.

b. The High Tech Credit.

The high tech credit was originally patterned after the federal research and development credit with the hope that it would foster technology businesses and investments in Hawaii. The high tech credit as enacted, however, is not limited to research and development as defined under the Internal Revenue Code, but rather is a general business credit with generous allowances and no accountability.[34] The result is the potential for high revenue losses without identifiable or measurable benefit to the State.

Some of the issues surrounding the high tech credit can be illustrated as follows:

(i) 100% Credit for Movies

The revenue impact of the movie production portion of the credit may far exceed the legislature's original expectations. For example, consider the movie "Waterworld" that was made in Hawaii in the early 1990's, and reputedly cost over $150 million. If "Waterworld" were produced in Hawaii today, the entire $150 million could theoretically be underwritten by the State under this portion of the high tech credit.

(ii) Requests for Ruling

In the past two years, over 100 requests for rulings on various high tech ventures have been granted by the Department of Taxation. Because ruling requests generally describe hypothetical situations with hypothetical numbers, because one ruling can represent one project or many, and because no one knows how many projects will actually be funded, the revenue impact is unknown.

(iii) Lack of Economic Substance for Allocation of High Tech Credits

Under federal tax law, a partner's distributive share of partnership income, deductions or credits must meet economic substance tests.[35] The high tech credit specifically nullifies these tests, and allows the LLC or partnership to allocate the high tech credit to partners without regard to economic substance.[36] As a result, the partner receiving the tax benefit of the credit may not be the investor who contributed the capital that was at risk.

(iv) Nullification of the High Tech Credit Dollar Limitations

The high tech credit imposes a $2 million tax credit limitation on each taxpayer. By using partnerships, the 100% high tech tax credit can be immediately and efficiently distributed among as many taxpayers as necessary to extract the full 100% tax credit in 5 years.[37] It is therefore possible that if "Waterworld" were produced in Hawaii today, the entire $150 million cost could be commoditized, sold to investors, and offset against taxes or refunded by the State within five years.

(v) 200% Credit for High Tech Investment

The high tech credit only requires that more than 50% of the total business activity of the high tech entity actually be high tech in order to qualify for the credit.[38] This means that for every $200.01 invested in a high tech entity, $100.00 can be spent on non-high tech activity and the investor still gets to deduct the entire $200.01 investment, or 200% of what is actually expended on high tech activity.

c. The Energy Conservation Credit.

The energy conservation credit began in 1976 as a 10% credit for the cost of installing energy conservation systems.[39] At the time, it was considered a very generous credit in furtherance of the strong public policy to reduce America's dependence on foreign oil. Since that time, the credit amount has increased to 35% for solar energy systems and to 50% for ice storage systems.[40] It is now a very generous credit in support of the energy conservation business.

When originally enacted in 1976, the statute provided the tax credit to the taxpayer who "purchased and placed in use"[41] the energy conservation system. As energy systems are fixtures or structural components, the taxpayer taking the credit was the owner of the building or the beneficial user of the energy conservation system.

In 1987, the capital goods excise tax credit was enacted, which provided a 4% credit for the cost of depreciable tangible personal property used by the taxpayer in a trade or business.[42] This credit encouraged the use of equipment leasing and the use of pass-through entities, such as partnerships, S-corporations, and business trusts in order to efficiently utilize the tax credits. To prevent abuse of tax credits, tax credits were subject to the partnership allocation rules of IRC § 704[43] and, upon disposition of any property, were subject to recapture of the credit under IRC § 47 (as of December 31, 1984) in order to prevent churning of the credit, i.e., multiple taxpayers claiming the 4% credit each time the property was sold.[44]

By analogy to the capital goods excise tax credit, taxpayers began to use equipment leasing and pass-through entities in order to efficiently utilize the energy conservation credit. The problem with this analogy is that the energy conservation credit was not designed for ownership of the energy fixtures to be detached from the building and purchased and sold like the tangible personal property subject to the capital goods excise tax credit. The energy conservation credit does not recapture the credit upon the sale of the energy fixture to another owner.

For example, a taxpayer, using equipment leasing and pass-through entity concepts, could install an ice storage system for $10 million, take the 50% tax credit and pass it though to its members, and then sell the ice storage system to another pass-through entity. Each succeeding owner could claim that it "purchased and placed in use" the ice storage system and is therefore entitled to the 50% tax credit. It would therefore theoretically be possible to claim $20 million in tax credits over the 20 year life of a $10 million ice storage system.

Enforcement through the audit process can be very difficult because the members of the pass-through entity are only obligated to fill in a number on their respective tax returns in order to take the credit. An auditor looking at the number has no information on the tax return from which to determine the nature of the energy device, where it is located, what entity owns it, how much it cost, or whether the credit is properly allocated.

According to the Department of Taxation, over $40 million in ice storage systems are being considered for completion by July 1, 2003. Based on this estimate, if the 50% credit is taken only once, the revenue impact will be over $20 million.

5. Recommendations on Specific Credits.

The Commission's recommendations with respect to specific business incentive tax credits are as follows.

a. Ethanol Production Facility Credit

A potential 240% refundable tax credit for amounts invested in an ethanol production facility is fiscally unsound and represents a poor return on the public's tax dollars. The public cost of the credit must be commensurate with the public benefit. A cost benefit study should be performed, and the amount of the credit reduced to the amount of the public benefit. Furthermore, due to the size and complexity of this credit, the taxpayer developing the ethanol production facility should report back to the legislature to justify the investment costs upon which the credit is based, account for all credits taken, and demonstrate that the cost-benefit has been achieved. The Tax Department should receive adequate resources to properly enforce this credit.

b. High Tech Credit

A potential 200% tax credit for every dollar invested in high tech with no enforceable limits is fiscally unsound and represents a poor return on tax dollars. The public cost of the credit must be commensurate with the public benefit. A cost benefit study should be performed, and the amount of the credit reduced to the amount of the public benefit. Furthermore, every business receiving $2 million in high tech investment should report back to the legislature to justify the investment costs upon which the credit is based, account for all credits taken, and demonstrate that the cost-benefit has been achieved. Additionally, the allocation of credits among investors should be based on economic substance to avoid potential abuse in selling the credits. The Tax Department should receive adequate resources to enforce this credit.

Activities qualifying for this credit should be tailored to be more cost effective to the State and should specifically target the benefits the State expects to receive. The tax credit for movies, in particular, should be more closely tailored to the benefits the State expects to receive. For example, it could be changed to a refundable credit equal to 30% of a movie's Hawaii production costs, as opposed to the 100% tax credit under current law. Even a 30% credit would significantly offset the higher cost of producing a film in Hawaii. If a larger credit is provided, the State should require that the taxpayer make a commitment to engage in performing art activities in Hawaii for a period of time, with partial recapture if such activities cease prematurely.

c. Energy Conservation Credit

A potential 50 % tax credit each year of the 20 year useful life of the $40 million in ice storage systems planned for the immediate future is fiscally unsound and represents a poor return on tax dollars. The public cost of the credit must be commensurate with the public benefit. A cost benefit study should be performed, and the amount of the credit reduced to the amount of the public benefit. Through the legislative process, the following problems should be addressed: (1) transferring ownership of fixtures or structural components, (2) sale and distribution of energy credits, (3) implementation of anti-churning provisions, (4) the issue of permitting energy credits for existing energy systems already installed by non-profits, as a matter of equity and fairness, and finally (5) the revenue impact of these various expansions of the energy credit.

C. General Excise Tax

In terms of tax policy, the Hawaii General Excise Tax has much to commend itself. It casts a wide net over virtually all forms of consumer activity, no matter how defined. When sales taxes were passed in the 1940's, sales of tangible goods comprised a majority of the economy, services only a minority. Today the situation is reversed. States have the politically challenging and complex task of extending traditional sales taxes to cover services. Sales taxes are further compromised because mail order and e-commerce sales put out-of-state merchants beyond the reach of state sales tax authorities. Throughout this never-ending commotion of changing economic activity, the General Excise Tax remains serene. It already taxes virtually all forms of consumption, no matter how defined.

Another benefit of the wide net cast by the General Excise Tax is the consistent revenue growth that has allowed low tax rates to remain. The General Excise Tax has generated revenues commensurate with the economic growth of Hawaii, even though the economy has changed dramatically over the past forty years, from agriculture to military to tourism. The current rate of 4% is one of the lowest in the country. Only Alaska has a lower rate, after combining the average state, city and county sales and gross receipts tax rates.[45]

1. Limit Additional Exemptions.

The General Excise Tax base on consumer transactions should be kept broad.[46] Exemptions for clothes, food, housing and other transactions are not the appropriate mechanism for reducing the regressiveness of the GET. The use of exemptions creates substantial administrative, compliance, and economic costs. Increased low-income tax credits (along with the increase in personal exemptions and broadening of the tax brackets discussed below) against the personal income tax are a more effective means of achieving the desired degree of vertical equity in the overall tax system.

2. Limit Credits Against Other Taxes.

Tax credits against other taxes, where possible, should be avoided.[47] Some credits are likely to be motivated more by political rather than economic attractiveness, and are as likely to harm as to help the long-term performance of the Hawaii economy. Some credits are also likely to create significant administrative difficulties for the Department of Taxation, as well as uneven tax burdens across firms. Existing credits and exemptions should be examined closely.

3. Reduce Tax on Business-to-Business Transactions.

Commitment to good tax policy would encourage legislation (1) codifying the objective of the General Excise Tax to subject consumption to a 4% GET only once, [48] and (2) initiating the process of rewriting the specific statutory language which is causing the present double taxation, by inviting industry groups to work with the Department of Taxation to reduce this problem.

4. Rewrite the GET Law to Achieve Transparency and Clarity.

Since its inception in 1935, the GET has been constantly revised, but never rewritten. As a consequence, it fails the tests of simplicity and transparency because important provisions are not always explicit or easy to find. For example, the question of whether the GET applies to the sale of leasehold interests in real property is an everyday question that affects many taxpayers, yet this very important subject is not covered in the GET statutes. The GET is generally administered to exempt the sale of leasehold interests in real property because of its similarity to the sale of land in fee simple, which is expressly exempted under HRS §237-3(b). This administrative interpretation was developed over the last 50 years in order to create a level playing field between land sold in fee simple and sales of leasehold interests. This administrative practice reflected the social policy concern of the very high cost of real estate during this period, but was never formally adopted in the GET statutes.

D. Taxation of Nonprofit Organizations

In general, the Commission believes that the State of Hawaii's taxation of nonprofit organizations should conform to federal law. An exception may be in the area of the GET. As discussed by Dr. William F. Fox, in his study "Should the Hawaii General Excise Tax Look Like Other States' Sales Taxes?" (See Appendix A.), the Hawaii GET is more akin to a broad based sales or consumption tax levied on all sales of goods and services to final consumers, than a privilege tax on vendors.[49]

As a tax on consumption, Hawaii nonprofit organizations should pay GET on their sales of goods and services[50], and not pay GET on other forms of income such as gifts and pure contribution activities. This would put the nonprofits on a par with for profit organizations, and greatly simplify the existing rules of taxation which exempt activities that are in the public interest but tax activities that are primarily to raise funds.

The current law is difficult to administer and creates confusion and therefore lack of compliance by nonprofit organizations. Purchases of goods and services by nonprofits would then follow the normal business to business rules of GET taxation.[51]

The Commission also believes that nonprofit organizations and other taxpayers who claim exemptions from GET should be required to compute and report the amount of GET saved from each exemption claimed on their GET returns so that the Department of Taxation will have the ability to capture this data on its computers and audit these returns. The Commission believes that this should result in enhanced compliance, and allow the State to conduct cost-benefit studies for each type of GET exemption.

E. Net Income Tax

Hawaii's net income tax rates are very high for both the rich and the poor. The May 27, 2002 edition of Forbes magazine points out at page 131 that the marginal Hawaii income tax rate is 8.25% on the wealthy (greater than $80,000 in taxable income), while The Honolulu Advertiser, on March 31, 2002, points out on the editorial page that a family of four qualifying for welfare with income at 125% of the poverty line, pays $756.00 in State income tax (second highest in the nation). If the State cannot afford to immediately reduce net income taxes, it should make a commitment to phase in over time a higher standard deduction, a higher personal exemption, and wider marginal tax brackets. The standard deduction and personal exemptions should be indexed with inflation, as should the tax brackets. These recommendations have been made on a consistent basis in the reports of previous Tax Review Commissions.

1. Increase the State Standard Deduction to the Federal Amount.

In 1984, when the standard deduction was $1,000 for a joint return, the Tax Review Commission recommended increasing the State standard deduction to $3,400 for a joint return to match the federal standard deduction.[52] The State standard deduction had not been adjusted in 20 years, had not kept up with inflation, and no longer provided equity to the poor. In 2001, the State standard deduction was $1,900[53], and the federal standard deduction was $7,600.[54] This is the major reason why the State unnecessarily continues to tax persons with income levels that qualify for public assistance.

2. Increase the State Personal Exemption to the Federal Amount.

In 1984, the State personal exemption had recently been raised to $1,000 to match the federal personal exemption.[55] In 2001, the State personal exemption was $1,040[56] and the federal personal exemption was $2,900.[57] This is the second major reason why the State continues to unnecessarily tax families with income levels that qualify for public assistance. Once established at the Federal amount, the personal exemption should be increased annually with inflation.

3. Wider Marginal Tax Brackets.

The State income tax brackets are so compressed that persons on public assistance pay income taxes, and the highest marginal rate for married taxpayers filing jointly begins when their taxable income reaches $80,000. The State income tax brackets should be expanded so that: (a) persons on public assistance do not have to pay State income tax, and (b) the highest marginal rate of 8.25% does not begin for married taxpayers filing jointly until their taxable income reaches at least $100,000. (One should note that for 2002, the highest marginal federal income tax rate for married taxpayers filing jointly is projected to start when their taxable income reaches $307,050.)[58]

4. Increase Federal Conformity.

In the 1970's, State net income tax conformity to the federal net income tax law was so great that a complicated federal net income tax return with schedules A, B, C, D, and E could be submitted as the State tax return with a one page cover sheet reconciling the small differences between the State and federal net income tax laws. Such a one page reconciliation could not be done today due to the large number of special provisions that have crept into the Hawaii net income tax law. Different provisions add complexity and tend to decrease equity. In essence, if the State were to simply readopt federal conformity, without the special provisions that have been added over the past 20 years, the State net income tax system would be significantly more efficient and simpler to administer. State conformity to the federal standard deduction and personal exemption would also restore equity for the poor, and eliminate the need for the assortment of special consumer credits which were provided in the past.

5. Conform with Federal Filing Deadlines.

It may now be more confusing for the Department of Taxation to have different filing deadlines for income tax returns than the IRS, especially when the State relies upon the federal income tax system to determine State income tax liability, and many federal and State income tax returns are now prepared by computer or filed on-line.

There is, in particular, no reason for the State to have shorter income tax filing deadlines than the IRS. HRS §235-98 currently provides that "Except in the case of persons who are outside of the United States, no extension [for filing an income tax return] shall be for more than six months." When corporations become members of or leave consolidated groups, or there are other types of corporate reorganizations, the IRS may provide for filing extensions of more than six months. Such taxpayers may have little practical choice but to disregard the State's shorter filing deadlines, because they cannot realistically complete their State income tax return until their not yet due federal income tax return is completed.

F. Taxation of Retirement Income

Andrew Mason prepared a report for the Commission on "Aging, Pension Income, and Taxes in Hawaii", August 30, 2002 (See Appendix B.). The purpose of this report was to address the issue of the impact on tax revenues of the exemption of pension income from State income tax over the next 75 years, taking into consideration the aging of the population in the US in general, and Hawaii in particular. This study also considers the impact of Tax Information Release 96-5, August 14, 1996, which results in taxing most distributions from 401(k) retirement plans, and the expected shift in pension income from traditional pension plans to 401(k) plans over the next 75 years.

The Commission concluded, based on the above study, that the expected tax revenue lost by the pension exemption due to the aging population, is significantly offset, over the 75 year period, by the shift in the character of retirement income from traditional pension plans (which are exempt from taxation) to 401(k) plans (which are generally taxable). One answer, therefore, would be to continue monitoring the situation and make no change in the exemption for retirement income, as the expected tax revenue lost by the expected aging population in Hawaii should be significantly offset by the shift in popularity to taxable 401(k) and similar deferred compensation plans.

Based on its charge to review the tax laws from the view of equity and fairness, the Commission recommends that all forms of retirement income should be taxed the same, regardless of its source from 401(k) plans, pension plans, profit sharing plans, IRA, SEP, 457 plan, or 403(b) plans. The current dichotomy between the taxation of traditional pension plans and the newer "deferred compensation" arrangements does not meet the test of fairness or equity.

The Commission believes, however, that any changes in this area should be made with great care and only after additional analysis. For example, if the legislature decides to repeal the current exemption for any type of retirement income, the Commission believes that such repeal should have a delayed phase in and not apply to persons who retire before that date, in order to not penalize current and prospective retirees who have made their financial plans based on the exemption of their current and future retirement benefits. The Commission also believes that the problem of low-income retirees' reliance on tax exempt pension income can be addressed by increasing the lowest income tax bracket, the amount of the personal exemption, and the standard deduction, to insure that persons qualifying for public assistance and other low income taxpayers will no longer be subject to Hawaii income tax.

G. Estate and Transfer Tax

Although the Commission generally supports conformity with the provisions of the federal Internal Revenue Code, there are times when conformity results in an unfair shifting of tax revenue from the State to the federal government. The repeal of the federal estate tax under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") is an example of such legislation. Although the federal estate tax is repealed over a 9 year period, the repeal of the state death tax credit is phased in over a 4 year period. Many states, like Hawaii, rely on this federal state death tax credit (often referred to as a "pick up tax") for their state death tax revenue.

The various states have reacted differently to the repeal of the state death tax credit by EGTRRA. Some have enacted their own, self contained, death tax laws, not related to the federal state death tax credit rules. Others have ignored the changes made by EGTRRA to the estate tax laws and continue to collect the "pick up tax" as if the federal changes, including the increase in the unified credit amount, had not been made. Both of these alternatives would, over time, result in the need for significant administration and enforcement by the Hawaii Department of Taxation.

Since the State Estate Tax is only approximately 0.6% of total tax revenues[59], adding this additional layer of administration and enforcement is not warranted.

The Commission recommends that the State of Hawaii conform with all of the Federal Estate Tax repeal provisions of EGTRRA except the repeal of the State of Hawaii Death Tax Credit. The Commission believes that the State should continue to collect its share of the "pick up tax" based on the credit schedule in effect prior to its reduction and repeal by EGTRRA. This “decoupling” would establish a new Hawaii Estate Tax which is based on a fixed percentage of a declining Federal Estate Tax. Although this would result in the repeal of the new Hawaii Estate Tax if the Federal Estate Tax is repealed as set forth in EGTRRA, it would be a simple way for Hawaii to continue to recover some State death taxes until the Federal repeal in 2010, or if the Federal Estate Tax is not repealed.[60] If the Federal repeal occurs, the Commission recommends that the State of Hawaii review the matter of a State death tax at that time.

H. Department of Taxation Operations

1. Monitor the Tax Credits.

Enacting business incentive tax credits without accountability is akin to asking taxpayers to fill out a blank check at public expense. If the State makes the political decision to enact business incentive tax credits, then it should also dedicate the resources necessary to properly determine and account for these credits. The Commission believes that accountability is the backbone of sound tax policy, and that without it, the tax system will be open to non-compliance and abuse.

2. Conduct Out-of-State Tax Audits.

An unfortunate effect of across the board budget cuts when there is no money is the cutting of expenditures that actually generate more money than they spend. For example, out-of-state audits were revived in the late 1980's, in part because a reporter wrote a 5-part expose about the Department of Taxation not being able to enforce State tax laws. The legislature gave the Department of Taxation money and positions. According to the Department, auditors went out-of-state for the first time in almost 20 years and returned with $100 for every dollar spent. The audits were primarily "welcome audits", visiting large interstate corporations and inviting them to pay their fair share of Hawaii taxes. In the 1990's, the Department suffered budget cuts and virtually no out-of-state audits were undertaken.

Since it has again been almost 20 years, the Legislature should again consider giving the Department money and positions for out-of-state audits. This time, the taxes collected should be accounted for and a special fund set up to insure that out-of-state audits continue for as long as they collect more dollars than they spend. Unlike other special funds, this one would not suffer from lack of legislative purview, because its purpose would be to provide additional revenue to the State General Fund.

I. Revenue Sufficiency for Future Needs

The present tax structure will not provide adequate revenues to meet current State spending needs over the next five years. At page 6 of the report on Tax Adequacy in Hawaii, attached as Appendix C, Dr. Bruce Kimzey concludes that revenues will be insufficient through 2005, and marginally sufficient in 2006 and 2007. As stated in the report, the projections are more optimistic than the projections of the Department of Budget and Finance. The report also cautions that it does not take into account unforeseen negative events, such as the events of September 11, 2001, which led to an actual decline in revenues of $250 million, or 8% of the general fund.

These revenue sufficiency projections also do not take into account the potential shortfall in revenue that may be caused by widespread use of the business incentive tax credits enacted in the past few years. As discussed above, these credits are generous, open-ended, and there is no way to determine the extent to which taxpayers will take advantage of these credits. A $30 million movie could cost the State $30 million in tax credits, or 1% of the general fund.

Although strongly recommended by each of the previous Tax Review Commissions, no serious consideration has been given to establishing a fund to truly stabilize year to year expenditure fluctuations caused by fluctuations in the State's tax revenues. The last 20 years have been a roller coaster ride for State tax revenues and, consequently, for State expenditures. The State has had a boom and then a bust. The 1989 Tax Review Commission prepared compelling and detailed recommendations for fiscal stabilization funds that would conserve a portion of the projected $1.8 billion surplus in order to counter a potential global recession in the future.[61] The revenue and expenditure experience of this State over the past 20 years, which has now encompassed a boom-and-bust cycle, presents compelling testimony for the need to establish a fund to truly stabilize State expenditures.

J. Enhancement of Research and Modeling Capabilities

Over the course of its meetings, the Commission has identified and discussed a long list of questions about Hawaii's tax system. Given the budget, only a few could be studied in detail. (See consultants' reports in the appendices.) The Commission therefore recommends that the State invest additional resources in tax research.

1. Enhanced General Research Capabilities.

The Tax Department's existing Division of Tax Planning and Research is essentially fully occupied with maintenance of tax-related data bases, and with day-to-day support of the legislature, the Council on Revenues and the like. However, techniques and data for economic modeling and forecasting have advanced considerably in recent years. The Tax Department's research staff does not have the time or expertise necessary to adapt these techniques to Hawaii's particular context, not to mention continuing use and maintenance. For example, the Council on Revenues would be greatly aided by improved forecasting models. Similarly, so-called "dynamic scoring" models would greatly help the legislature and executive branch to evaluate proposed tax policy changes. These models incorporate not only the direct impact of a proposed change, but also the adaptations made by business and consumers seeking to minimize their tax outlays under the new tax rules. A "rapid response" capability based on a portfolio of these models would greatly facilitate executive and legislative decisions.

The Department of Business, Economic Development and Tourism (DBEDT) has a larger research staff in its Research and Economic Analysis Division. DBEDT tends not to study taxation matters directly or comprehensively, since taxes are the concern of another department. Of course, any expanded research resources for the Tax Department should be closely coordinated with DBEDT's general modeling and economic analysis efforts.

2. Specific Questions.

The following list illustrates the range of questions to which added research capabilities could be applied productively:

a. Tax incentives

As noted above, there is a growing list of incentives provided through the tax system, with little information available about the revenue losses sustained by the State and the economic or other benefits traceable to these incentive programs. The Tax Department should be charged with, and given resources sufficient to (a) performing cost/benefit studies of proposed tax incentives and subsequent incentive awards, covering social and broad economic effects as well as the pure revenue implications; (b) monitoring the results of these awards to assure specific, contractual goals are achieved; (c) periodically evaluating each incentive program for continued effectiveness.

b. Auditing activity

Additional auditing activity could generate higher tax revenues and improve taxpayer compliance, but also will have a cost. The benefit and costs of additional auditing resources deserve investigation, particularly for unpaid use taxes by out-of-state firms.

c. Nonprofit organizations

The Department of Taxation currently knows very little about the operations of nonprofit organizations beyond their unrelated business income. The Legislature should consider requiring §501(c)(3) organizations to file a copy of their federal form 990 with the Department of Taxation so that their activities can be monitored and their compliance with their charitable objectives can be determined.

d. Conformity with federal tax laws:

What would be the revenue effects of increasing the state's standard deduction to the federal amount? Likewise with the personal exemption. These possibilities need to be studied in the context of a dynamic scoring model, accounting for incentive effects of tax changes.

e. Equity concerns

Dr. Fox's report on the General Excise Tax noted the principle that the tax base should be as broad as possible, in spite of potential equity concerns. What is the extent and significance of these equity concerns? What would be the effects of creating an income tax credit to compensate for GET taxes paid on food, medical care or other categories of expenditure for the poor?

f. Bracket creep

What would be the effect of adjusting tax brackets for inflation, in the same manner as federal tax brackets are adjusted, to avoid the bracket creep problem?

g. Administrative costs

Some changes in taxation seem desirable in principle, but also seem to present difficult administrative problems. Modeling of proposed tax changes should include the administrative costs and feasibility of such changes. For example, the Capital Goods Excise Tax Credit is an inefficient way of providing an incentive to businesses buying capitalized goods in Hawaii, by returning the GET paid on the goods through a credit. A more efficient approach would be to exempt these purchases from GET for qualifying purchases. Is this feasible? How would the exemptions be implemented and monitored? What would be the impact on revenue?

K. Other Considerations

1. Overhaul and Update the Capital Goods Excise Tax Credit.

The four percent capital goods excise tax credit was originally enacted in 1987. The effect of the credit is essentially to refund the GET and Use Tax paid on capital goods by businesses.[62]

The credit was designed to alleviate the cost of acquiring capital goods which has long been acknowledged to be important for the creation of jobs, and was patterned after the federal investment tax credit with references to former IRC §§38 and 48, which have now been repealed for over ten years. As a result, administration and compliance with the provisions of the capital goods excise tax credit have been less than forthright. Recent interpretations of the credit have resulted in applications that may stray from the original intent and letter of the former Federal statutes.

The Commission therefore recommends that HRS §235-110.7 be revised or rewritten as a whole to provide contemporary definitions and provisions under State law, rather than relying on outdated Federal statutes.

The Commission also recommends that any new statute allow a credit for otherwise depreciable items which are deducted under IRC §179.

2. State Corporate Tax Revenue Trends.

In the report on State Corporate Tax Revenue Trends attached as Appendix D, William F. Fox and LeAnn Luna seek to investigate the extent to which state corporate income tax revenues nationwide have declined and some ways to reverse the pattern.

The report identifies four sources of the deterioration in state corporate tax revenues: (a) cyclical declines in profits, (b) reductions in the federal corporate tax base, (c) state policy decisions to reduce corporate tax burdens, and (d) more aggressive corporate tax planning.

The Commission supports Fox and Luna's conclusion that states, including Hawaii, are confronted with two options if they want to replace the revenues with greater taxation of business; either find new means for taxing businesses, or revise the corporate income tax to overcome the existing problems.

In Hawaii, State corporate income tax revenue declined 10.9% from $68,215,000 in fiscal year 2000 to $60,793,000 in fiscal year 2001.[63] Its close relative the financial institutions franchise tax also declined from a positive $7,057,000 to a negative $294,000 during this period.[64]

ENDNOTES

[1] Hawaii Revised Statute ("HRS") § 232E-3
[2] State Tax Policy, A Political Perspective, David Brunori, The Urban Institute Press, 2001, p. 15.
[3] Id.
[4] National Conference of State Legislatures ("NCSL"), 1992, p. 7.
[5] State Tax Policy, Brunori, p. 15.
[6] Id.
[7] NCSL, 1992, p.7.
[8] State Tax Policy, Brunori, p. 16.
[9] Id.
[10] Id.
[11] Id.
[12] Id. p. 17.
[13] Id.
[14] Id. p. 18.
[15] Id. p. 19.
[16] Id.
[17] Id.
[18] Id.
[19] Id. p. 20.
[20] Id. p. 22.
[21] Id. p. 23.
[22] Id. p. 24.
[23] Id.
[24] Id. p. 27.
[25] Id.
[26] Id.
[27] "Should the Hawaii General Excise Tax Look Like Other States' Sales Taxes?", Dr. William Fox, revised October 15, 2002, pp. 46-53.
[28] Id. p. 57.
[29] "Effects of State Tax Incentives", Terry F. Buss, Economic Development Quarterly, Vol. 15 No. 1, February 2001, pp. 90-105.
[30] Honolulu Star Bulletin, July 11, 2002, p. A4.
[31] Letter dated August 8, 2002 from the Tax Foundation of Hawaii to the Tax Review Commission.
[32] State Tax Policy, Brunori, p. 37-42.
[33] HRS §235-110.3(b).
[34] HRS §235-110.9.
[35] IRC §704.
[36] HRS §235-2.45(e).
[37] HRS §235-110.9(a).
[38] HRS §235-110.9(e)(1).
[39] HRS §235-12 (1976); see also HRS §235-12(a)(1998).
[40] HRS §235-12 (1998).
[41] HRS §235-12 (1976); see also HRS §235-12(a) and (c) (1998).
[42] HRS §235-110.7.
[43] HRS §235-2.45(e).
[44] HRS §235-110.7(d).
[45] "Should the Hawaii General Excise Tax Look Like Other States' Sales Taxes?", Dr. William Fox, revised October 15, 2002, p. 12.
[46] Id. p. 54.
[47] Id. p. 55.
[48] Id. p. 56.

[49] "Should the Hawaii General Excise Tax Look Like Other States' Sales Taxes?", Dr. William F. Fox, revised October 15, 2002, p. 3.
[50] Id. p. 55.
[51] Id. p. 56.
[52] 1984 Tax Review Commission Report, p. 13.
[53] HRS §235-2.4(a).
[54] IRC§63(c).
[55] 1984 Tax Review Commission Report, p. 13.
[56] HRS §235-54.
[57] IRC§151.
[58] IRC§1(a).
[59] "Tax Adequacy in Hawaii", Bruce W. Kimzey and Brent D. Wilson, September 2002, Table 3 p. 3.
[60] As of October 2, 2002, sixteen states (Kansas, Maine, Maryland, Massachusetts, Minnesota, Nebraska, New Jersey, New York, North Carolina, Oregon, Pennsylvania, Rhode Island, Vermont, Virginia, Washington, and Wisconsin) and the District of Columbia have "decoupled".
[61] 1989 Tax Review Commission Report, pages 24 to 33.
[62] See "Should the Hawaii General Excise Tax Look Like Other States' Sales Taxes?", Dr. William F. Fox, revised October 15, 2002, p. 20.
[63] Annual Report 2000-2001, Department of Taxation, State of Hawaii, p. 19.
[64] Id. p. 26.

LIST OF APPENDICES

Appendix A	“Should the Hawaii General Excise Tax Look Like Other States’ Sales Taxes?”, Dr. William F. Fox (Revised October 15, 2002).
Appendix B	“Aging, Pension Income, and Taxes in Hawaii”, Andrew Mason (October 9, 2002).
Appendix C	“Tax Adequacy in Hawaii”, Bruce W. Kimsey and Brent D. Wilson (Revised October 29, 2002).
Appendix D	“State Corporate Tax Revenue Trends: Causes and Possible Solutions”, William F. Fox and LeAnn Luna (June 5, 2002).
Appendix E	Letter dated August 8, 2002 from the Tax Foundation of Hawaii to the Tax Review Commission.