



**REPORT OF THE**  
**1995 - 1997 TAX REVIEW COMMISSION**

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## LETTER OF TRANSMITTAL

## **PREFACE**

This is the report of the 1995 - 1997 Tax Review Commission ("Commission"). It is the work of nine residents of the State: seven Commission members, a secretary, and a researcher/writer. The next page lists the names of Commission members and summarizes the Commission's structure.

The Commission members donated their time. A detailed statement of expenses will be provided with testimony at the Legislature.

The Commission wishes to acknowledge the Department of Taxation for its technical and administrative assistance, and the Department of Budget and Finance, the Department of Business and Economic Development, Lowell Kalapa of the Tax Foundation of Hawaii for providing data and comments to the Commission, and George Freitas, former Director of Taxation for his insightful comments and thoughts. The Commission also wishes to express its appreciation to Marcia Y. Sakai, Commission member, for sharing her invaluable thoughts and insights on economics with the other Commission members. In addition, the Commission extends its appreciation to those people who attended the Commission's meetings and public hearings or provided other input. The Commission found their thoughts very useful.

**THE 1995 - 1997 TAX REVIEW COMMISSION**

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## REPORT OF THE 1995-1997 TAX REVIEW COMMISSION

### I. FRAMEWORK

#### A. Mandate.

At the direction of the people of Hawaii, through the Constitutional Convention of 1978, the Tax Review Commission of the State of Hawaii ("Commission") is charged with the duty to "conduct a systematic review of [Hawaii's] tax structure, using such standards as equity and efficiency."<sup>1</sup> This Commission is to present the 1997 Legislature with "an evaluation of the State's tax structure and recommend revenue and tax policy ...."<sup>2</sup> After careful review of time and budgetary constraints, this Commission limited its scope to Hawaii's general excise tax, use tax, and net income tax. These taxes account for over 80 percent of Hawaii's state government tax revenues.

#### B. The Commission's Criteria for Evaluation .

Section 232E-3 of the Hawaii Revised Statutes ("HRS") states that the Tax Review Commission shall conduct its review of the State's tax structure using such standards as equity and efficiency.<sup>3</sup> This Commission considered the following factors in its review: equity, efficiency, simplicity, stability and predictability, adequacy and accountability, and competitiveness. The Commission defined these factors in order to arrive at a common understanding of each factor. To a fair extent, this Commission adopted the definitions enumerated by the 1989 Tax Review Commission.

The purpose of defining a set of criteria for evaluating the tax structure is to provide a common, general framework that policymakers can refer to when policy options are considered.<sup>4</sup> Ideally, any potential change to the tax structure should be judged against these criteria, and policy choices should be made based on how they fit into the overall fiscal framework rather than on an ad hoc basis to meet short term needs.<sup>5</sup> The Commission believes that each criterion listed represents a desirable characteristic of a good tax structure. The following criteria are listed in order of importance as generally agreed upon by the Commission, although it should be noted that the individual commissioners differed to some extent on the importance and weighting of these criteria.

**1. Equity.** Fundamentally, Hawaii's tax system should be fair to all taxpayers. Taxpayers in similar circumstances should be taxed alike.<sup>6</sup> Looking at the tax structure as a whole, taxpayers in dissimilar circumstances should be taxed based on their ability to pay.<sup>7</sup> Since government derives its authority from its citizens, the system of taxation must be fair to all citizens. There should be no preference given to special interests.

**2. Efficiency.** Hawaii's tax system should not cause significant changes in a taxpayer's economic behavior.<sup>8</sup> It should not cause taxpayers to structure their activities to avoid a tax or

to gain a tax advantage.<sup>9</sup> This can be achieved by keeping tax bases broad and tax rates low.<sup>10</sup> Moreover, taxpayers should be able to compete on a "level playing field" where taxes do not confer an advantage to one taxpayer over another taxpayer.<sup>11</sup> However, the Commission believes that it is appropriate to export a reasonable share of the tax burden to those living outside of Hawaii who benefit from publicly provided services.

**3. Simplicity.** Hawaii's tax system should be easily understood by affected taxpayers.<sup>12</sup> In addition, these taxpayers should be able to comply with Hawaii's tax system without much expense or difficulty.<sup>13</sup>

**4. Stability and Predictability.** Hawaii's tax system should permit taxpayers to plan for the future with some certainty as to the impact of taxes.<sup>14</sup> The system should not require wide swings in expenditures or revenues as economic conditions change.<sup>15</sup>

**5. Adequacy and Accountability.** Hawaii's tax system should not generate more revenue than necessary.<sup>16</sup> Further, this system should provide visible links between revenue raising responsibility and spending authority.<sup>17</sup> Such links should be visible to enable voters to hold elected officials responsible for both revenue and spending decisions.<sup>18</sup>

**6. Competitiveness.** Hawaii's tax system should compare favorably with the tax systems of other states and jurisdictions so that it does not deter people from living in Hawaii and conducting business in the State.<sup>19</sup> This criterion envisions a competitive overall tax system. This criterion should not be used, however, to justify providing preferential treatment to certain taxpayers. Further, while it may be desirable to "export" the burden of taxation to visitors, any attempt to do so must be carefully analyzed in terms of its effect on Hawaii's competitive position in the worldwide marketplace. Since Hawaii competes globally as a tourist destination, the State must remain alert as to potential losses of visitors due to its tax burden.

During the course of the Commission's review and discussion, members discovered that at times some factors were at odds with other factors. Because of this, the Commission weighted these factors based on the members' judgments as to the relative importance of each factor. The Commission believed that the factors of equity and efficiency were of paramount importance. Therefore, whenever the factors of equity and efficiency weighed in favor of a certain recommendation while one or two of the other factors weighed in favor of another result, the Commission usually chose the equity and efficiency favored recommendation. With this framework in mind, the Commission makes the following recommendations.



## **II. RECOMMENDATIONS AND ANALYSIS**

**The Commission makes several recommendations to broaden the general excise tax base by eliminating preferential treatment for certain taxpayers. In addition to eliminating the piecemeal granting of exemptions, the Commission recommends modifying the treatment of service businesses by clarifying and expanding the existing intermediary services provision of the law, eliminating certain exemptions intended to reduce the pyramiding aspect of the general excise tax, and increasing compliance by not-for-profit organizations. Ideally, this might enable the State to provide broad tax relief by lowering the 4.0 percent general excise tax rate.**

**As to the net income tax, the Commission recommends that relief be provided to all individual taxpayers by increasing the standard deduction and personal exemption amounts, expanding the tax brackets, and reducing the number of tax rates. The Commission also recommends changes to the tax treatment of pension income, capital gains, tax-deferred transactions, and nonresidents.**

**The Commission believes that Hawaii's economy is more dependent upon small businesses and the service industry than it was when the major tax laws were originally drafted and when the agriculture and manufacturing industries represented the primary source of export income.<sup>20</sup> The State's tax structure should ensure that small businesses and the service sector are treated equally with the agriculture and manufacturing sectors.**

**The tax burden on Hawaii residents is high. The Commission believes that only if government spending is reduced, can Hawaii effectively reduce its taxes so as to provide real equity for Hawaii's taxpayers. In fiscal year 1993, Hawaii ranked 4th highest in the nation for state and local government per capita direct general expenditures (\$5,465 per person).<sup>21</sup> To reduce costly delivery of government services, the State must seek best value by seriously investigating alternative methods of service delivery, including, where appropriate, the use of modern technology, privatization, and direct competition with the private sector. Furthermore, Hawaii's expenditures and taxes should be made more visible to enable voters to hold elected officials accountable for both revenue raising and spending decisions.**

**The estimated tax revenue impact of this Commission's recommendations will be provided in testimony before the Legislature.**

## A. GENERAL EXCISE TAX

The general excise tax is a tax on the gross proceeds of sales and is levied on enterprises for the privilege of doing business in the State of Hawaii.<sup>22</sup> It is not a sales tax, but a tax on gross receipts.

Hawaii's general excise tax is remarkable for the breadth and depth of its coverage.<sup>23</sup> It applies to virtually all sales of goods and services in the State, not merely at the retail level but also as they are sold by the wholesaler, the manufacturer or the producer.<sup>24</sup> Consequently, products passing within Hawaii's economy are subject to repeated taxation under the general excise tax.<sup>25</sup> In contrast, other states' sales taxes, with few exceptions, are limited to retail sales of goods, occasionally including some services but generally exempting food, medicines or other categories or merchandise.<sup>26</sup>

Hawaii's general excise tax is imposed on all manufacturers, sellers of tangible personal property, contractors, theaters, sales representatives, service businesses, insurance solicitors and agents, professionals, and other businesses.<sup>27</sup> Generally, retail, service and contracting businesses are taxed at 4.0 percent while wholesalers and manufacturers are taxed at 0.5 percent.<sup>28</sup> Under very limited circumstances, intermediate service providers are also taxed at the 0.5 percent rate. The rate at which a business is taxed depends on the type of activity or transaction being conducted. For example, the 0.5 percent rate applies when a manufacturer sells its goods to a retailer for resale. However, the 4.0 percent rate applies to the same manufacturer when it sells the same goods to the ultimate user of those goods.<sup>29</sup> As a practical matter, most businesses pass the general excise tax on to their customers at the compounded rates, such as 4.166 percent at the retail level.

A more comprehensive example follows. A manufacturer produces a good and sells it to a wholesaler for \$100. The manufacturer is subject to tax at a rate of 0.5 percent on \$100 on this transaction. The wholesaler then sells the same good to a retailer for \$200. The wholesaler is taxed at a rate of 0.5 percent on \$200 on this transaction. In turn, the retailer sells the good for \$300 to the ultimate consumer. The retailer is taxed at a rate of 4.0 percent on his gross revenue of \$300. The general excise tax is levied on each of these transactions. In addition, the manufacturer, the wholesaler, and the retailer may each include the general excise tax on other goods and services, which are incorporated into their overhead cost, in their own prices. For example, if the retailer subleases its store premises, the lessor and sublessee each pay four percent general excise tax on the rent, which is built in to the retailer's occupancy cost.

The general excise tax is imposed on "gross income."<sup>30</sup> "Gross income" is calculated "without any deductions on account of the cost of property sold, the cost of materials used, labor cost, taxes, royalties, interest, or discount paid, or any other expenses whatsoever."<sup>31</sup> Because of its breadth and depth, the general excise tax generated over 52 percent of Hawaii's general fund revenue for fiscal year 1994.<sup>32</sup> Exemptions to this tax and the lower 0.5 percent rate have eroded the base of this tax and reduced somewhat its revenue raising abilities.

The current general excise tax structure has numerous preferences and exemptions. The Commission identified equity as a factor of utmost importance for Hawaii's tax system. Any exemption or preference that treats any one taxpayer or any class of taxpayers differently from others raises a question as to equitable tax treatment, since it effectively shifts one taxpayer's burden to all other taxpayers. Equity is important in maintaining the integrity of the tax system. The availability of preferences might cause taxpayers to lose faith and fall out of the system.

A tax on gross receipts without any deductions whatsoever necessarily imposes itself at every stage of business. The imposition of tax at each successive level of a transaction is sometimes described as a "pyramiding" of the tax, and described by some to produce significant negative consequences. However, a gross receipts tax such as the general excise tax pyramids by its very nature.

If the Legislature desires to address particular social or political concerns, it should first try to address those concerns through direct expenditures or the net income tax system. In general, the Legislature should not tinker with the general excise tax system by creating new exemptions or anti-pyramiding provisions except to eliminate inequities. Alternatively, the Legislature can consider other forms of taxing systems, such as the value-added tax or retail sales tax, to replace the general excise tax altogether.

**The Commission's general excise tax recommendations are presented in the following order: (1) eliminate or limit exemptions from the general excise tax; (2) clarify and expand the intermediary services provision to include a wholesale services concept; (3) eliminate or limit provisions intended to eliminate pyramiding of the general excise tax; (4) increase not-for-profit organizations' compliance with the general excise tax by clarifying the exemption for not-for-profit organizations and requiring new compliance reporting for not-for-profit organizations; (5) exempt exported services; (6) extend the exemption for not-for-profit hospitals, infirmaries, and sanatoria to all skilled nursing facilities and for-profit hospitals, infirmaries, and sanatoria; (7) consider a reduction in the general excise tax rate for all taxpayers when viable; and (8) consider a sales tax or value-added tax as an alternative to the general excise tax.**

**1. Eliminate or Limit Exemptions From the General Excise Tax.** Hawaii's general excise tax is a broad-based tax. This is recognized as a positive feature of the tax. As a general rule, the number of exemptions should be minimized to prevent erosion of the broad tax base and to avoid increased complexity in administration of the tax. Similarly, exemptions which have expired should be removed from any mention in the HRS.

**a. Eliminate or Limit Exemptions Which Are Intended to Effect Social Policy But Which Are Not Based On Ascertainable Needs.** There are certain exemptions which appear motivated by social policy, but which are granted without regard to individual financial need. Such blanket exemptions do not necessarily further any equity or efficiency purpose (as defined by this Commission). Tax benefits should only be provided to a class of

disadvantaged individuals based on actual need. If there is a legitimate social policy which the State desires to encourage, it should be explicitly identified so that the most appropriate policy (e.g., direct expenditures, reduced tax rates, net income tax credits, or exemptions from tax) may be implemented. The Commission recommends that these social policy issues be addressed primarily with direct expenditures or perhaps by the net income tax system.

General excise tax exemptions which should be repealed on this basis include the \$2,000 exemption for blind, deaf, or totally disabled persons<sup>33</sup> and the exemption for Hansen's disease patients.<sup>34</sup>

The Commission also recommends limiting the application of the 0.5 percent general excise tax rate for taxpayers with impaired sight, hearing, or totally disabled to a reasonable gross receipts amount per year. The Commission believes that \$30,000 per year is a reasonable amount.<sup>35</sup>

The Commission also considered elimination of the exemption for gross proceeds from the sale of prescription drugs or prosthetic devices to any individual<sup>36</sup> on the same basis. The Commission recognizes that high medical costs present a serious policy issue for the State. The Commission believes that an income tax credit for lower income Hawaii residents with costly medical needs might be a preferable tax solution. The Commission determined, however, that the complexity involved for qualified residents to claim an income tax credit, and for the State to administer a credit, might create significant inefficiencies. Accordingly, repeal of this particular exemption is not proposed at this time.

**b. Subject Exemptions Which Are Intended to Stimulate Development of New Industries in Hawaii to Automatic Phase-Out and Sunsetting.** The Commission believes that exemptions intended to stimulate industries in Hawaii should be created and maintained very sparingly, if at all. The Commission recognizes that there may be economic justification for general excise tax exemptions for businesses in startup industries which the State desires to encourage. In this instance, the Commission is willing to consider the issue of competitiveness. Nevertheless, these exemptions must be bounded by the primary standards of equity and efficiency.

Such exemptions should be granted only for a reasonable startup period. The Commission suggests that a reasonable startup period might be no longer than five (5) years. Such exemptions also could be subject to a phase-out during the startup period.

These limitations recognize that there should be equity in the tax treatment of competing industries, and would mitigate against businesses in a new industry having an unfair advantage over businesses in different industries. Automatic sunseting of such exemptions at the end of the reasonable startup period would serve efficiency purposes, since marginal or nonviable industries should not be indefinitely subsidized by the State.

To treat all industries evenly, the Commission has identified the following exemptions which should be repealed and/or not reinstated:

- 1) exemption for producers of motion picture or television films<sup>37</sup>;
- 2) exemption for gross proceeds from the retail sale of alcohol fuels<sup>38</sup>; and
- 3) stock exchange exemption.<sup>39</sup>

**c. Eliminate or Limit Exemptions or Special Rates Which Indefinitely Benefit a Particular Industry or Taxpayer.** There are numerous exemptions or special tax rates which benefit a particular industry or taxpayer. Because such preferential treatment are inequitable to other taxpayers, the Legislature must systematically and periodically review each of these and repeal those which have no compelling economic or other justification.

The Commission has identified the following industries or taxpayers currently benefiting from such exemptions<sup>40</sup>:

- 1) *industries with scientific contracts with the United States* (HRS § 237-26 regarding the exemption for gross proceeds from certain scientific contracts with the United States);
- 2) *petroleum refiners* (HRS § 237-27 regarding the exemption for value of petroleum products refined in Hawaii which is to be further refined by another refiner in Hawaii);
- 3) *agriculture* (HRS § 237-24.3(1) regarding loading, transporting, and unloading agricultural products);
- 4) *sugarcane producers* (HRS § 237-24(14) regarding the sale of sugarcane products);
- 5) *certain contractors to the federal government* (HRS § 237-13(3)(C) regarding certain cost reimbursements made to federal cost-plus contractors and HRS § 237-25 regarding sales of tangible personal property to the federal government and credit unions);
- 6) *labor organizations* (HRS § 237-24.3(10) regarding certain real property rental income);
- 7) *common carriers in interstate or foreign commerce*<sup>41</sup> (HRS § 237-24.3(2)(C) regarding the exemption for sales of agricultural, meat, or fish products grown, raised, or caught in Hawaii, to any person or common carrier in interstate or

foreign commerce for consumption out-of-state);

- 8) *air pollution control facilities* (HRS § 237-27.5 regarding the exemption of amounts received from the sale of tangible personal property furnished in conjunction with, the construction, reconstruction, erection, operation, use, or maintenance of an air control facility); and
- 9) *solid waste processors* (HRS § 237-27.6 regarding the exemption for all amounts arising from a transaction involving a sale and leaseback of a solid waste processing, disposal, and electric generating facility entered into by a political subdivision of the State and where the facility is owned or under construction by the subdivision before May 10, 1988).

Further, the State should eliminate the special general excise tax rate for insurance solicitors and agents. The current law allows insurance solicitors and agents to be taxed at a rate of 0.15 percent on commissions earned through the sale of insurance. Other taxpayers who earn their income based on commissions (e.g., realtors) are taxed at 4.0 percent. Based on considerations of equity and efficiency, the Commission recommends eliminating the 0.15 percent rate for insurance solicitors and agents and imposing the 4.0 percent rate currently imposed on other commissions-earning taxpayers.

The enactment of the 0.15 percent rate on commissions earned from the sale of insurance was concurrent with an increase in the rates of tax imposed on insurance company receipts of insurance policy premiums. The increase in premium rates was intended to offset the revenue loss from the decrease in the commission rate from 4.0 percent to 0.15 percent. Therefore, premium tax rates should be reviewed at the same time any action is taken on raising the tax rate on commissions.

**2. Clarify and Expand the Intermediary Services Provision to Include a Wholesale Services Concept.** The Commission believes that providers of services and certain other activities should be taxed in a manner similar to sellers of tangible personal property in the wholesale-retail-customer context. As such, all parties in the chain of business transactions are taxed at the 0.5 percent or 4.0 percent rates.

Under HRS § 237-13(6), taxpayers providing "intermediary services" are taxed at the 0.5 percent rate. On its face, this provision in the general excise tax law seems simple. However, the interpretation of which services qualify for "intermediary services" treatment has been extremely unclear. Furthermore, the Department of Taxation ("DOT") has permitted this provision to be applied only in very limited circumstances.

Because of the current uncertainty as to the application of the law and the DOT's narrow approach, the Legislature must grapple with the "intermediary services" issue. This issue is extremely important because of the State's current service-based economy.

The Commission recommends expanding and clarifying the definition of "intermediary services" to include:

- 1) the sale of a service to a person licensed under the general excise tax law and engaged in the service business; provided that (A) the service sold is not consumed or incidental to the performance of the services; and (B) there is a resale of that service at the retail rate of four percent; or
- 2) the sale of "wholesale services."

This recommendation is intended to extend the current general excise tax treatment for sellers of tangible goods at wholesale to providers of services at wholesale. In order to qualify under these rules, the intermediary service cannot be modified in any substantial manner by the reseller of that service prior to resale.

The first definition of "intermediary services" above is derived from the current provision of the law defining the sale of tangible goods at wholesale.<sup>42</sup> This definition is intended to apply to situations in which an intermediary service provider performs different types of services than the reseller of that service. Under this definition, the services performed by a certified public accountancy ("CPA") firm engaged by a law firm to analyze financial statements for the law firm's client would qualify as intermediary services. As such, the CPA firm would be taxed at the 0.5 percent rate on the amount received for its services.

The second definition of "intermediary services" introduces the "wholesale services" concept. Under this concept, wholesale service providers are taxpayers who provide services or activities to another service provider for an ultimate third party consumer. In order to qualify under this definition, the wholesale service provider must provide or conduct "like or similar services or activities" as the retail service provider who orders or arranges for the wholesale service or activity. The wholesale service provider would be taxed at a rate of 0.5 percent on the amount received for its services.

The "wholesale services" concept can be illustrated as follows. A small CPA firm is engaged to conduct an audit of the financial records of a third party consumer. However, the audit requires more personnel hours than could be performed by the CPA firm's personnel. To remedy the situation, the CPA firm contracts with another CPA to perform some of the audit work which is to be incorporated into the audit report for the ultimate consumer. In this case, the CPA who performs the additional audit work is taxed a wholesale service provider rate of 0.5 percent on his fee and the CPA firm is taxed at rate of 4.0 percent on its audit fee.

In addition, the wholesale services concept should be extended to the leasing of real property. Thus, the wholesale service provider in a multiple-lease transaction would be taxed at the 0.5 percent rate on its gross receipts.

For example, Taxpayer 1 holds the lease on a parcel of real estate. Taxpayer 1 subleases that parcel to Taxpayer 2 who in turn sub-subleases it to a third party user of that parcel of real estate. In this case, Taxpayer 1 is a wholesale service provider and is taxed at the 0.5 percent rate on its gross proceeds. Taxpayer 2 is a retail service provider and is taxed at the rate of 4.0 percent on its gross proceeds. However, the wholesale services concept would not apply to situations where Taxpayer 1 develops or improves the real property before subleasing it to Taxpayer 2. Thus, the wholesale services concept would only apply to situations where there were no substantial changes to the parcel of real property.

By its redefinition of "intermediary services," the Commission intends to broaden the application of "intermediary services" to situations not previously permitted by the DOT.

**3. Eliminate or Limit Provisions Intended to Eliminate Pyramiding of the General Excise Tax.** The Commission considered several different alternative methods to address the subject of the pyramiding aspect of the general excise tax.<sup>43</sup> For example, the Commission considered the elimination of pyramiding altogether by replacing the current general excise tax with a retail sales tax, a non-pyramiding general excise tax using the concept of direct use, a net excise tax, or a value-added tax. The Commission also considered the elimination of several specific exceptions to pyramiding under current law. These specific exceptions included, but were not limited to, the contractor-subcontractor deduction<sup>44</sup>, the tour packager-tour agent exception<sup>45</sup>, and community association reimbursements exception.<sup>46</sup> After careful consideration, the Commission makes the following recommendations.

The general excise tax should be imposed on all gross receipts derived from business activity without the benefit of any deductions. Splitting of gross receipts between different taxpayers for general excise tax purposes should not be permitted. In essence, this allows one taxpayer to deduct the portion of gross proceeds given to another taxpayer. This violates the general concept of a tax on gross receipts without deductions and the wholesale-retail-customer concept.

The following "anti-pyramiding" exemptions which permit gross receipts splitting should be eliminated:

- 1) coin operated devices<sup>47</sup>;
- 2) gate receipts<sup>48</sup>;
- 3) insurance agents and realtor commissions<sup>49</sup> (For the Commission's recommendation to increase the general excise tax rate on commissions earned by insurance solicitors and agents, see Section II.A.1.c. above.);
- 4) tour packager/travel agent<sup>50</sup>;



- 5) hotel operator payroll<sup>51</sup>; and
- 6) orchard operator payroll.<sup>52</sup>

The Commission believes that some of these taxpayers might instead qualify for wholesale services treatment, as discussed in Section II.A.2. above, which would allow them to be taxed at the 0.5 percent rate instead of the 4.0 percent rate. Alternatively, some of these taxpayers might qualify for exemption of some portion of their gross receipts under the existing agency and reimbursement provisions of HRS § 237-20. The Commission notes that HRS § 237-20 also probably deserves further review since its current application by the DOT seems unduly narrow.

The general excise tax is, and should be, limited to gross receipts derived from the conduct of business activity.<sup>53</sup> The general excise tax should not be imposed on receipts which are not derived from business activity. On this basis, the following exemptions under the current law are justifiable as expressly excluding certain non-business receipts from the general excise tax: (1) association of apartment owners and community association reimbursements<sup>54</sup>; (2) unincorporated merchants associations dues<sup>55</sup>; and (3) common paymaster and related entities.<sup>56</sup>

As stated above, the Commission believes that the splitting of gross receipts between taxpayers should not be permitted because it deviates from the "gross receipts without any deductions" principle. The Commission understands, however, that the social policy of reducing the tax burden on the ultimate consumer may override this principle. These exceptions to the "gross receipts without any deductions" principle must be limited. The Commission currently recognizes only one situation in which a gross receipts splitting might be retained. As a way to reduce housing costs for Hawaii residents, the contractor-subcontractor deduction would remain in existence. If the wholesale services concept discussed in Section II.A.2. above were adopted, however, then wholesale services treatment might be a preferable approach to the current contractor-subcontractor deduction.

**4. Increase Not-For-Profit Organizations' Compliance with the General Excise Tax Law.** In general, the Commission is concerned that there is a lack of compliance with the general excise tax law by not-for-profit organizations.

**a. Clarify the Exemption Pertaining to Not-For-Profit Organizations.**

The Commission believes that the major reason for the lack of compliance is a lack of clarity in the law as to what is exempt and what is not exempt from general excise tax.

Under current law, dues, contributions, and other similar type of receipts received by a not-for-profit organization are exempt from general excise tax. In addition, receipts from activities engaged in by the organization are exempt if the primary purpose of the activity is (1) not to produce income and (2) a primary reason for the organization's existence.<sup>57</sup>

The exemption does not apply, however, to receipts derived from activities for which the primary purpose is to produce income. Such activities should be taxed identically to for-profit organizations' activities. This is the case even though such income is to be used for or in furtherance of the exempt purpose of the organization.<sup>58</sup> Thus, receipts from primarily income producing activities, including fundraising, are subject to general excise tax. Equity compels this result.

**b. Require New Compliance Reporting for Not-For-Profit Organizations.** The Commission believes that another reason for lack of compliance by not-for-profit organizations might be that such organizations are not generally subject to any licensing and tax reporting requirements. Therefore, the Commission recommends that, subject to the conditions described below, all not-for-profit organizations should be required to: (1) obtain a general excise tax license and (2) file general excise tax returns on an annual basis in order to claim any exemptions from the general excise tax. Such a requirement would familiarize not-for-profit organizations with the procedure for filing general excise tax returns and improve compliance by organizations with taxable gross receipts.

The Commission does not intend these requirements to cause hardship on not-for-profit organizations, especially smaller volunteer organizations whose activities do not generate substantial amounts of revenue. In order to make these requirements less burdensome to these organizations, the Commission recommends that: (1) the filing fee for obtaining a general excise tax license be waived for not-for-profit organizations; and (2) the annual general excise tax return be required only if a not-for-profit organization has annual gross receipts, including exempt activity income, of \$30,000 or more.

**5. Exempt Exported Services .** The Commission recommends that an exemption from general excise should be granted for income from services performed for out-of-state customers. The 1989 Tax Review Commission also recommended such an exemption.<sup>59</sup>

At least one commissioner opposes the exemption for exported services as well as the existing exemption for exported goods. That commissioner feels that these exemptions are inequitable in that they favor Hawaii taxpayers that serve customers outside of the State. As with any preference, the tax burden is shifted, in this case from taxpayers who are fortunate enough to sell their product or service outside of the State to taxpayers serving Hawaii customers. The Hawaii product or service is cheaper for the nonresident customer than for the resident customer. Such a subsidization is justifiable only if the State derives some "trickle-down" benefit from the revenues derived by these non-taxpayers of the State. The Commission, as a whole, believes the exemptions are necessary to make Hawaii businesses competitive in other markets. This is an example of competition prevailing over equity.

**6. Extend the Exemption for Not-For-Profit Hospitals, Infirmaries, and Sanitaria to All Skilled Nursing Facilities and For-Profit Hospitals, Infirmaries, and Sanitaria.** The current law exempts revenue generated from the activities of not-for-profit hospitals, infirmaries, and sanitaria.<sup>60</sup> The Commission acknowledges that there might be a compelling rationale for exempting such activities, *i.e.*, Hawaii residents undergoing medical procedures at these institutions should not be unduly burdened by being required to pay general excise tax on these procedures. Equity requires that taxpayers attending for-profit institutions should not be required to pay general excise tax on medical services. In addition, the Commission believes that the same rationale applies to services rendered by skilled nursing facilities. The definition of "skilled nursing facility" provides a bright-line distinction. Therefore, the Commission recommends that this exemption be expanded to include all skilled nursing facilities and for-profit hospitals, infirmaries, and sanitaria. If health care is developed as a major industry in Hawaii, however, this recommendation may need to be reviewed.

**7. Consider a Reduction in the General Excise Tax Rate When Viable.** If existing exemptions from the general excise tax are significantly curtailed and future exemptions are not freely granted, an overall reduction in the 4.0 percent general excise tax rate should be considered. A reduction in the total tax burden for Hawaii taxpayers would better promote Hawaii as a place to live and conduct business.

**8. Consider a Sales Tax or Value-Added Tax as an Alternative to the General Excise Tax.** As a general rule, the Commission believes that the general excise and use tax structure is a productive revenue-generating system. However, the myriad of exemptions has caused inequities in the existing tax system and has made these taxes unduly complicated for taxpayers. The Commission believes that, if the Legislature is unwilling to resist the temptation of granting new exemptions or to repeal existing exemptions which do not further efficiency or equity, voluntary compliance will be discouraged.

To increase compliance and eliminate much of the effort now exerted to classify transactions into one or more categories, the Legislature might consider a single uniform tax rate for general excise and use taxes instead of the current differing wholesale and retail rates.

As a less desirable and more drastic alternative, replacement of the general excise and use tax with a sales tax (consumption tax) or value-added tax (non-pyramiding business tax) could be considered. In addition, the significant changes in how business is done which have already begun and will no doubt continue in the future (*e.g.*, with use of computers and other electronic means in a worldwide market) might make a sales tax more practical to administer.

## **B. USE TAX**

The use tax is designed to supplement the general excise tax and is imposed on the use in the State of Hawaii of tangible personal property which is imported, or purchased from a seller outside of the State.<sup>61</sup> The use tax is intended to create an even playing field for taxpayers doing business in Hawaii and paying the general excise tax by being imposed on the use within Hawaii of tangible personal property imported from out of State or purchased from a Hawaii seller who is not paying general excise tax. The use tax applies where: (1) a person acquires tangible personal property from an out-of-state seller for use in Hawaii or (2) where a person acquires tangible personal property within the State from persons not taxable on the transaction under the general excise tax.<sup>62</sup>

**1. Extend the Use Tax to Imported Services.** The Commission recommends that services purchased from an out-of-state service provider be subject to a use tax payable by the Hawaii purchaser of the service. Under current law, use tax is imposed on a Hawaii purchaser of goods from an out-of-state vendor<sup>63</sup> but not on a Hawaii purchaser of services from an out-of-state provider. The Commission's recommendation would put a Hawaii purchaser of out-of-state services in the same position as a Hawaii purchaser of goods from an out-of-state vendor. The 1989 Tax Review Commission also endorsed such an extension of the use tax.<sup>64</sup>

## **C. INDIVIDUAL NET INCOME TAX**

With some exceptions, Hawaii's net income tax law essentially mirrors that of the federal net income tax system. Hawaii's net income tax is imposed upon individuals, corporations, estates, and trusts.<sup>65</sup> Generally, resident individuals, corporations, estates, and trusts are taxed upon their entire income regardless of source. Hawaii also taxes all taxpayers domiciled in the State although not necessarily residents of Hawaii. Domestic corporations are taxed upon their entire income, except to the extent the income is allocated to other jurisdictions. Nonresidents and foreign corporations are taxed on income from sources in Hawaii.<sup>66</sup>

In the past, the State's use of income tax credits has been a notable progressive characteristic of the State's tax structure.<sup>67</sup> These credits were conceived primarily to provide relief to lower income taxpayers, working parents, promote energy conservation, and foster public safety.<sup>68</sup> Recently, however, several tax credits have been eliminated or substantially reduced in value. For example, the 1995 Legislature repealed the "excise tax credit," an income tax credit intended to provide relief to lower income taxpayers.<sup>69</sup>

In addition, qualified residents of all income levels were entitled to the food, dependent care, energy, medical services excise, capital goods excise, and the child passenger restraint tax credits.<sup>70</sup> Of these, only the capital goods excise and child passenger restraint tax credits were available to nonresidents.<sup>71</sup> For tax year 1995, the amount of the food tax credit was reduced to \$27 per qualified resident.<sup>72</sup> The Legislature also repealed one part of the medical services excise

tax credit beginning in 1995.<sup>73</sup> Prior to 1995, the medical services excise tax credit provided a credit for a taxpayer's qualified medical expenses and certain nursing facility expenses. However, the Legislature retained only the nursing facility excise tax credit portion of the medical services excise tax credit.<sup>74</sup> This credit is due to expire on June 30, 1997.<sup>75</sup>

Hawaii's net income tax is assessed against every individual who receives gross income in excess of certain thresholds:

-For single or legally separated individuals: \$2,540, for individuals under 65 ; \$3,580, for individuals 65 or older.

-For a married couple filing jointly: \$3,980, if both are under 65; \$5,020, if one is 65 or older; \$6,060, if both are 65 or older.

-For married persons filing separately: \$1,990, for individuals under 65; \$3,030, for individuals 65 or older.

-For a single head of household: \$2,690, for individuals under 65; \$3,730, for individuals 65 or older.

-For a qualifying widow or widower with a dependent child: \$2,940, for individuals under 65; \$3,980, for individuals 65 or older.

These thresholds are higher for persons who are blind, deaf, or totally disabled and who have completed and filed a doctor's certification of such disability.

**The Commission's individual net income tax recommendations are presented in the following order: (1) increase the standard deduction amounts; (2) increase the amount of each personal exemption; (3) expand the tax brackets and reduce the number of tax rates; (4) change the capital gains tax rate; (5) change the tax treatment of pension income; (6 ) revise Hawaii's method of taxing nonresidents; (7) limit the availability of tax-deferred treatment; (8) eliminate certain provisions of the State's net income tax law and continue to conform with the federal income tax law; and (9) conform to federal requirements for an automatic extension of time to file a tax return.**

**1. Increase the Standard Deduction Amounts.** Although the Hawaii standard deduction amount has increased over the years, the current Hawaii standard deduction amount (under HRS § 235-2.3) remains substantially lower than the basic federal standard deduction (under the Internal Revenue Code of 1986, as amended, ("IRC") Section 63) which is adjusted annually for inflation.

Since the standard deduction is an alternative to itemizing deductions, an increase in the standard deduction will assist lower income taxpayers. Because a variety of State income tax

credits have been repealed, additional relief for lower income taxpayers is appropriate. Further, Hawaii's low standard deduction causes many taxpayers to take itemized deductions for State income tax purposes while at the same time taking the standard deduction for federal purposes. This makes it more difficult for taxpayers to file their income tax returns. The Commission believes that increasing Hawaii's standard deduction would provide some relief for the lower income taxpayers and make it simpler for these taxpayers to file their income tax returns. The Commission recommends increasing the standard deduction to roughly 40 percent of the basic federal standard deduction, as set forth below:

	Hawaii		Federal
	<u>1996</u>	<u>Proposed</u>	<u>1996</u>
- Married persons filing jointly and surviving spouses	\$1,900	\$2,600	\$6,700
- Heads of household	\$1,650	\$2,300	\$5,900
- Single taxpayers	\$1,500	\$1,560	\$4,000
- Married filing separate returns	\$ 950	\$1,310	\$3,350

**2. Increase the Amount of Each Personal Exemption.** Hawaii's personal exemption of \$1,040 per person has not changed for inflation or cost of living adjustments. For federal tax purposes, each personal exemption for the 1996 tax year is \$2,550. This amount is adjusted each year for inflation. Hawaii's personal exemption should be increased to \$1,500 to allow for the cost of living and inflation adjustments.

**3. Expand the Tax Brackets and Reduce the Number of Tax Rates.** Currently, the highest marginal tax rate for individuals is 10 percent. The Commission believes that this rate should not be any higher.

The Commission believes that Hawaii's individual taxpayers' income begins to be taxed at the State's highest marginal tax rate much too soon. Because of this, the Commission recommends expanding the tax brackets such that the level of income which begins to be taxed at the 10 percent rate is higher than the current amount. In addition, to simplify the tax structure, the Commission recommends a reduction in the number of marginal tax brackets.

The following schedules attempt to accomplish these goals.

Schedule I  
Single Taxpayers and Married Filing Separate Returns

Taxable Income	
Not over \$1,500 . . . . .	2%
Over \$1,500 but not over \$5,250 . . . . .	3%
Over \$5,250 but not over \$20,000 . . . . .	7%
Over \$20,000 but not over \$40,000 . . . . .	8%
Over \$40,000 . . . . .	10%

Schedule II  
Married Taxpayers Filing Joint Returns  
and Certain Widows and Widowers

Taxable Income	
Not over \$3,000 . . . . .	2%
Over \$3,000 but not over \$10,500 . . . . .	3%
Over \$10,500 but not over \$40,000 . . . . .	7%
Over \$40,000 but not over \$80,000 . . . . .	8%
Over \$80,000 . . . . .	10%

Schedule III  
Unmarried Heads of Household

Taxable Income	
Not over \$3,500 . . . . .	3%
Over \$3,500 but not over \$10,500 . . . . .	6%
Over \$10,500 but not over \$41,000 . . . . .	8%
Over \$41,000 . . . . .	10%

**4. Change the Capital Gains Tax Rate.** The Commission considered four different alternatives to address the issue of Hawaii's capital gains income tax rate.

One alternative was to lower the current maximum long term capital gains rate for individuals of 7.25 percent<sup>76</sup> to 4.0 percent (which is the current maximum long-term capital gains rate for corporations) based on the argument that such a reduction would reward those who invest their capital. Encouraging the formation of capital in Hawaii for investment in Hawaii's economy is good public policy. The rate reduction would be a simple way to promote this policy.

The second alternative was to provide no preferential tax treatment for long term capital gains. Instead, all income would be taxed the same rate whether earned from working or benefiting from appreciation in the stock or real estate markets. This position did not advocate higher tax collections, but merely addressed an important question on allocating the tax burden. This position disagreed with the assumption that a tax cut for long term capital gains will significantly improve Hawaii's economy. This alternative recognized that the real needs were to reduce the total tax and regulatory burdens on Hawaii's taxpayers and to promote fairness.

The third alternative favored maintaining the status quo tax rate of 7.25 percent for long term capital gains (currently, for capital assets held longer than one year). The rationale for this alternative was that the slight benefit given to long term capital gains provided a simple and crude mechanism to offset the effects of inflation creating larger paper gains.

After lengthy discussions and analysis, the Commission agreed to recommend the fourth alternative: an adjustment of tax rates for long term capital gains depending upon the length of time one has held the asset. This recommendation increases the tax rate for short term asset holders and lowers the rate for those who owned the asset for more than five years. Assuming the current maximum ordinary income tax rate of 10 percent, the Commission recommends that the following tax rates apply to net gains from the sale of capital assets:

<u>Time Capital Asset Held</u>	<u>Maximum Tax Rate</u>
One year or less	10 percent
More than one year to five years	8 percent
More than five years	6 percent

The Commission recognizes that such a structure would slightly complicate Hawaii's taxation of net capital gains. However, the Commission believes that the rate reduction for long term investors is necessary to reduce taxation of gains arising because of inflation.

## **5. Change the Tax Treatment of Pension Income.**

**a. Exempt Additional Types of Pension Income.** Currently, HRS § 235-7 excludes from income "[a]ny compensation received in the form of a pension for past services". Because of this, the State exempts most forms of pension income from the net income tax. In 1994, the DOT issued a set of rules clarifying the exclusion of pension income from the net income tax. Under the DOT's rules, amounts distributed from individual retirement accounts, 401(k) plans, and qualified plans of self-employed individuals do not qualify for the exclusion because contributions to these plans were considered "elective". However, amounts distributed from nonqualified deferred compensation plans for company executives qualify for this exclusion. The DOT's rules favor participants in traditional pension plans at the expense of 401(k) participants, who must contribute their own money to receive a pension, individual retirement account contributors who may have no other pension, and self-employed individuals.



The Commission does not believe the rules adopted by the DOT are fair or based on sound tax or pension reasoning. Until such time as all pension income is subject to net income tax (see Section II.C.5.b. below), all types of the following retirement income should be exempt: (1) a qualified trust under Section 401(a) of the IRC that is tax-exempt under IRC Section 501(a) (a "qualified retirement plan"); (2) a simplified employee pension plan as defined in IRC Section 408(k) (a "SEP"); (3) an annuity contract described in IRC Section 403(a); (4) an annuity contract described in IRC Section 403(b); (5) an individual retirement plan described in IRC Section 7701(a)(37) (an "IRA"); (6) an eligible deferred compensation plan as defined in IRC Section 457; (7) a governmental plan as defined in IRC Section 414(d); or (8) a trust described in IRC Section 501(c)(18).

This recommendation makes the current law more equitable by extending exempt treatment to certain types of pension income that are currently taxable. However, the recommendation is meant only as an interim measure until pension income becomes subject to net income tax as discussed below.

**b. Phase-In Taxation of Pension Income Over a Reasonable Period of Time.** Currently, pension money is not taxed when it is contributed to a plan nor when it is distributed (provided it meets DOT's requirements). Therefore, pension money is never taxed under Hawaii law. Hawaii's exemption for pension income is inconsistent with federal law which taxes all qualified pension income when the income is distributed.

The Commission is unable to find any compelling reason not to tax pension income. The Commission believes that there is at least one compelling reason to tax pension income in the future. The State's demographics are such that in the future a greater percentage of the State's population will be retirees. If the current exemption for pension income continues to exist, the State's income tax base will be eroded and the State's tax revenue will be reduced. Therefore, it is imperative that the State begin to tax pension income at some point in the future.

Instead of delaying action until the tax base is eroded, the Legislature should act now to provide taxpayers with the opportunity to plan their affairs. The Commission recognizes that a net income tax on pension income may cause hardships on pension recipients. Therefore, the Commission recommends that the Legislature phase-in this tax over a reasonable period of time in order to provide the opportunity for taxpayers to plan accordingly. After such a phase-in period, the pension income exemption should be eliminated and all pension income should be subject to net income tax.

**6. Revise Hawaii's Method of Taxing Nonresidents .** Currently, nonresidents of Hawaii are only taxed on their Hawaii source income.<sup>77</sup> However, they are allowed full deductions for personal exemptions even though the income reported to Hawaii may be for only a small portion of the year or may be a small portion of the nonresident's total income for the year.<sup>78</sup> In addition, nonresidents who do not itemize are permitted to take standard deduction amounts equal to that of residents.<sup>79</sup> The Commission believes the current situation is not equitable for Hawaii residents because nonresidents are permitted to take the same amount of

deductions as residents while only a portion of the nonresidents' income is subject to Hawaii net income tax.

To alleviate some of this inequity, the Commission recommends that the State tax nonresidents using the method adopted by the states of California and New York.<sup>80</sup> The effect of the new method will be to subject more of a nonresident's income to the higher marginal tax rates than the current method permits.<sup>81</sup> The new method, while admittedly slightly more complicated than the current method, will require nonresidents to pay their fair share of net income tax to Hawaii.<sup>82</sup>

**7. Limit The Availability of Tax-Deferred Treatment.** Certain transactions result solely in a change in the form of a taxpayer's investment. However, the substance of that taxpayer's relative economic position remains the same as before the transaction occurred. In these specific situations, the income tax law provides that the gain or loss, which would otherwise be recognized, is postponed or deferred until the property received in the exchange is subsequently disposed of in a transaction which changes the substance of a taxpayer's economic position. For example, a taxpayer may make a tax-deferred exchange of a parcel of real estate used in a trade or business for a different parcel of real estate to be used in the taxpayer's trade or business.

The Commission recommends the following changes to Hawaii's law relating to tax-deferred transactions.

**a. Eliminate the Special Active Duty Military Personnel Exception for Nonrecognition of Gain On the Sale of a Principal Residence.** IRC Section 1034 provides for the nonrecognition of gain from the sale or exchange of a principal residence if the entire sale proceeds are reinvested in a replacement residence within two years from the date of sale or exchange. Tax deferral is permitted because the new residence is viewed simply as a continuation of the original investment.

Hawaii's income tax law does not presently conform to the federal tax law in this area in that tax deferral is permitted only to the following: (1) a taxpayer who purchases a replacement residence which is located within the State, and (2) a taxpayer who is a resident of the State, taxable upon the taxpayer's entire income, computed without regard to source within the State.<sup>83</sup> Therefore, gain on the sale of the replaced home may not be postponed if the taxpayer's replacement home is located outside of Hawaii or the taxpayer establishes a domicile outside of Hawaii at or by the time the taxpayer purchases the replacement property.

The Commission believes that the current law is reasonable because it enables the State of Hawaii to tax income that would otherwise permanently escape Hawaii income taxation. However, an exception to Hawaii's limited tax deferral rule exists for active duty military personnel stationed in Hawaii.<sup>84</sup> Hawaii permits nonresident active duty military personnel stationed in Hawaii to postpone the recognition of the gain on the sale of their Hawaii homes as if they were residents of the State of Hawaii both before the sale and after the purchase of the

replacement property even if their new residence is out-of-state.<sup>85</sup>

The Commission does not believe that it is equitable to treat nonresident active duty military personnel differently from other Hawaii taxpayers. To do so would allow individuals who have derived economic benefit within the State of Hawaii to permanently escape Hawaii net income tax on that economic gain. Therefore, the Commission recommends the elimination of the active duty military personnel exception.

**b. Limit Like-Kind Exchange Treatment to Situations Where the Taxpayer's Replacement Property Is Located in Hawaii.** Generally, IRC Section 1031 permits taxpayers to defer gain when property which is held for the productive use in a trade or business or for investment is exchanged for like-kind property which is also held for the productive use in a trade or business or for investment. However, the federal law only permits like-kind exchange treatment if the replacement property is located within the United States.

Hawaii tax law follows this federal rule and currently permits like-kind exchange treatment if the replacement property is located anywhere within the United States. Therefore, for Hawaii net income tax purposes, nonrecognition of gain applies even if the replacement property is located outside of the State of Hawaii.

The Commission believes that the treatment for like-kind exchanges should be permitted only if it is absolutely certain that the tax-deferred gain will eventually be subject to Hawaii net income tax upon a later sale or exchange of the replacement property. It is currently possible to permanently escape taxation on the tax-deferred gain. For example, a resident taxpayer may exchange its qualifying real property located in Hawaii for California real property. Subsequent to the exchange, the taxpayer changes its residency to another state. By changing its residency subsequent to the exchange, the tax-deferred gain for Hawaii purposes is never subject to Hawaii taxation. Because of the potential for avoiding Hawaii taxation on a subsequent sale of non-Hawaii replacement property, Hawaii's like-kind exchange treatment should only be permitted if the replacement property is located in Hawaii. This limitation is reasonable because it enables the State of Hawaii to capture income tax on gain that may otherwise permanently escape Hawaii net income taxation.

The Commission recommends that like-kind exchange treatment be limited to situations where the taxpayer's replacement property is located in Hawaii.

**c. Limit Involuntary Conversion Treatment to Situations Where the Taxpayer's Replacement Property Is Located in Hawaii.** Section 1033 of the IRC provides that a taxpayer who suffers an involuntary conversion of property may postpone recognition of gain realized from the conversion. Involuntary conversions may result from the destruction, theft, seizure, or condemnation or sale or exchange of the taxpayer's property under the threat or imminence of condemnation. The objective of this provision is to provide relief to the taxpayer who has suffered hardship and does not have the ability to pay tax on any gain realized from the conversion. Postponement of realized gain is permitted to the extent that the taxpayer

reinvests the amount realized from the conversion into replacement property within a certain period of time.

Hawaii follows this federal rule, permitting tax deferral on involuntary conversion gains even if the replacement property is located outside of Hawaii.

The Commission believes that the treatment for involuntary conversions should be substantially identical to the treatment of like-kind exchanges. The same potential for permanently escaping Hawaii taxation exists. The Commission recommends that involuntary conversion tax-deferred treatment be limited to situations where the taxpayer's replacement property is located in Hawaii. The Commission believes that this limitation is reasonable because it enables the State of Hawaii to capture income tax on gain that may otherwise permanently escape Hawaii net income taxation.

**8. Eliminate Certain Provisions of the State's Net Income Tax Law and Continue to Conform with the Federal Income Tax Law.** Because of simplicity concerns, the Commission believes that the State should conform to the federal net income tax law wherever and whenever possible.

The State should eliminate the following net income tax provisions to conform with federal net income tax law:

- a. the exclusion for members of the Hawaii national guard and military reservists<sup>86</sup>;
- b. the deduction for political contributions<sup>87</sup>;
- c. the deduction for individual housing accounts<sup>88</sup>; and
- d. the credit for purchasing a child passenger restraint system.<sup>89</sup>

The Commission recommends that the following provisions be eliminated only if the Legislature adopts the Commission recommendations to (1) increase the standard deduction and personal exemption amounts and (2) revise the net income tax rate schedules (as already set forth in this report): (a) the food tax credit<sup>90</sup>; and (b) the credit for child and dependent care expenses.<sup>91</sup>

The State should continue to conform to changes to the federal net income tax law. However, Hawaii should only conform to the extent that federal changes do not conflict with any expressed State social policy or concern.

**9. Conform to Federal Requirements for an Automatic Extension of Time to File a Tax Return.** At present, Hawaii grants automatic extensions of time for filing individual income tax returns only if the taxpayer has paid 90 percent of the tax due for the taxable year on

or before the original due date of the return and files an extension request. Any taxpayer who is determined not to have paid 90 percent of the tax due is retroactively denied the extension and may be assessed a late filing penalty of five percent of the tax due for each month that the return is late up to a maximum of 25 percent of the tax due. In such cases, the late filing penalty accrues from the date of the original due date of the return without regard to the extension request. The late filing penalty is in addition to: (1) a late payment penalty which may amount to 20 percent of the taxes not paid on time and (2) interest for late payment which is accrued at the rate of 2/3 of one percent for each month on all unpaid taxes and penalties assessed.

The Commission believes that the 90 percent prerequisite for receiving the extension is unfair to Hawaii's taxpayers. It is extremely difficult for taxpayers to estimate their income tax liability with sufficient accuracy to meet this requirement. In the cases of shareholders of S corporations and partners in partnerships, accurate financial information for the corporation or partnership is usually not available until after the original due date of the individual income tax return. This lack of information makes it nearly impossible to calculate 90 percent of the tax due for affected taxpayers. Furthermore, the federal automatic extension of time to file does not have such a condition.

Based on these factors, the Commission recommends that the 90 percent requirement to receive an automatic extension be eliminated. The granting of the automatic extension should be automatic as it is with the federal automatic extension.

#### **D. OTHER CONSIDERATIONS**

The Commission believes that Hawaii's tax system generates sufficient revenue to support expenditure growth that is consistent with the long run growth of the State's economy. Current general fund fiscal difficulties are not signs of revenue inadequacy. Rather, they are the result of a number of other factors: rapid and unsustainable government growth in the late 1980's, spending in excess of revenues and the expenditure ceilings in 1990 and 1991, diversion of general fund tax revenues into special funds, and a cyclical downturn in the economy in the early 1990's. See Appendix A (Revenue Statistics, Burden, Revenue Adequacy) of this report for further discussion on these matters.

The Commission takes a cautious view of increased State government imposition of new and/or higher user fees. To the extent that fees recover costs from direct beneficiaries of a public service, they act in the nature of market prices and represent an efficiency gain. Generally, fee amounts should be just sufficient to recover the cost of producing those public services. However, to the extent that policy makers use fees to supplement, rather than replace, tax revenues for the financing of existing services, they have effectively raised taxes. Failure to recognize this detracts from the visibility of the tax system.

The Commission also takes a cautious view of increased State government use of special

funds. The use of special funds might be justified to receive and distribute funds for enterprise-like programs, capital improvements, monies held in trust, and designated federal aid. This Commission believes that strict tests, which conform to these purposes, might be applied in the creation of special funds. The creation of special funds for user fees which substitute for general fund taxes and for earmarked general fund taxes are two examples which would fail the test. Improper use of special funds reduces accountability by reducing legislative oversight and public scrutiny. Further, such use reduces general fund expenditure flexibility, especially as monies begin to flow to funds outside the general fund.

**1. Establish a Stabilization Fund.** This Commission recommends the establishment of a formal general fund stabilization fund. Such a fund would accumulate tax revenues during periods of strong revenue growth for expenditure use during periods of weak or declining revenue growth.<sup>92</sup> This fund would stabilize year to year expenditure fluctuations caused by fluctuations in the State's tax revenues.<sup>93</sup>

This Commission believes that it is better to have a level trend in spending rather than to accelerate spending in good fiscal times and suffer severe spending cutbacks when fiscal stress occurs. This can be accomplished by the establishment of a formal general fund stabilization fund. These funds are not intended to cover all revenue shortfalls.<sup>94</sup> Sustained budgetary problems may indicate a need to re-evaluate the priority of expenditures and the revenue structure.<sup>95</sup> The 1984 and 1989 Tax Review Commissions also made this recommendation.<sup>96</sup>

**2. Limitations on the Scope of this Commission's Work.** The Commission decided to limit the scope of its work and to limit the extent of its budget requests, in consideration of the financial position of the State government. As a result, the Commission was unable to fully address certain issues. On such issue involves county revenues. While the Commission takes no position with respect to this issue, Appendix B of this report provides useful information on and analysis of county revenues.

## ENDNOTES

1. HRS § 232E-3 (Michie 1996); see also Haw. Const. art. VII, § 3 ("There shall be a tax review commission, which shall be appointed as provided by law on or before July 1, 1980, and every five years thereafter. The commission shall submit to the legislature an evaluation of the State's tax structure, recommend revenue and tax policy and the commission shall dissolve.").
2. HRS § 232E-3 (Michie 1996).
3. See supra notes 1-2 and accompanying text.
4. 1989 Ariz. Joint Select Comm. on State Revenues and Expenditures Rep.
5. Id.
6. 1989 Tax Review Comm'n Rep. 2.
7. See id. ("[T]axpayers in unequal circumstances should be taxed on the basis of their ability to pay ....").
8. See 1989 Tax Review Comm'n Rep. 3 ("The tax system should not interfere with private economic decisions.").
9. Id.
10. 1989 Ariz. Joint Select Comm. on State Revenues and Expenditures Rep. ("Avoid causing changes in economic behavior by keeping tax bases broad and marginal tax rates low.").
11. 1989 Tax Review Comm'n Rep. 3.
12. See id. ("The tax system should not be unduly difficult for taxpayers to comply with or for the government to administer. The cost of compliance and administration should not be out of proportion to the means at hand or the amount of tax involved.").
13. See id.
14. See 1989 Tax Review Comm'n Rep. 2 ("It should minimize the need for frequent or radical adjustments as economic conditions change and allow the government and taxpayers to make their plans with some certainty as to the impact of taxes.").
15. See 1989 Ariz. Joint Select Comm. on State Revenues and Expenditures Rep. ("Employ a system that does not produce wide swings in expenditures or revenues in response to economic cycles.").
16. See 1989 Tax Review Comm'n Rep. 2 ("[T]he system should not produce tax revenues in excess of what is needed.").
17. See 1989 Ariz. Joint Select Comm. on State Revenues and Expenditures Rep. ("Provide links between revenue raising responsibility and spending authority, so that voters can hold elected officials responsible for both revenue and spending decisions.").

18. Id.
19. See 1989 Tax Review Comm'n Rep. 3 ("The Hawaii tax system should compare favorably with the tax systems of other states so that it does not discourage people from living in Hawaii and conducting business here.").
20. The United States Department of Commerce, Bureau of the Census, County Business Patterns (1993) indicates that there were a total of 30,157 business establishments in Hawaii as of 1993. Of these, there were 25,952 businesses with 1 to 19 employees, and 4,205 businesses with 20 or more employees. There were 10,181 service businesses versus 1,013 manufacturing businesses.
21. United States Department of Commerce, Bureau of Census, and the Hawaii Tax Foundation.
22. R. Kamins & Y. Leong, Hawaii's General Excise Tax 1 (1963); see HRS § 237-13 (Michie 1996) ("There is hereby levied and shall be assessed and collected annually privilege taxes against persons on account of their business and other activities in the State measured by the application of rates against values of products, gross proceeds of sales, or gross income ....").
23. R. Kamins & Y. Leong, Hawaii's General Excise Tax 1 (1963).
24. Id.
25. Id.
26. See id.
27. W. Fox, Defining the General Excise Tax Base: Exemptions and Pyramiding 3 (1989).
28. See id.
29. See id.
30. See HRS § 237-3(a) (Michie 1996) providing:

"Gross income" means the gross receipts, cash or accrued, of the taxpayer received as compensation for personal services and the gross receipts of the taxpayer derived from trade, business, commerce, or sales and the value proceeding or accruing from the sale of tangible personal property, or service, or both, and all receipts, actual or accrued as hereinafter provided, by reason of the investment of the capital of the business engaged in, including interest, discount, rentals, royalties, fees, or other emoluments however designated and without any deductions on account of the cost of property sold, the cost of materials used, labor cost, taxes, royalties, interest, or discount paid or any other expenses whatsoever. ..."

31. Id.



32. See R. Kamins & Y. Leong, Hawaii's General Excise Tax 12 (1963); see also 1994-1995 Dep't. of Tax. Ann. Rep. 16 (stating that the general excise tax accounts for 52.4 percent of the State's general fund tax collections).
33. HRS § 237-24(13) (Michie 1996).
34. HRS § 237-23(a)(8) (Michie 1996).
35. Haw. Depart. of Tax., Tax Information Release No. 94-2 (March 15, 1994) limited the application of the exemption to the first \$30,000 of gross receipts received by a disabled person per year. The cap was tied to the maximum adjusted gross income amount a taxpayer was allowed to have and still qualify to claim the low-income portion of the food/excise tax credit.
36. See HRS § 237-24.3(7) (Michie 1996) (providing for an exemption for amounts received from the sale of prescription drugs or prosthetic devices).
37. HRS § 237-28.2 (Michie 1996) (This provision expired on July 1, 1976.).
38. HRS § 237-27.1 (Michie 1996).
39. HRS § 237-24.5 (Michie 1996) (This provision is due to expire on June 30, 2000.).
40. The interisland cruise line exemption pursuant to HRS § 239-11 (Michie 1996) (expired on June 30, 1996) is another example of taxpayers receiving special treatment in the public service company tax arena. Although this exemption is a public service company tax exemption and technically outside the Commission's stated scope of review, the Commission believes that this exemption should not be extended.
41. This exemption, in fact, has been deemed unconstitutional. See In Re the Tax Appeal of Hawaiian Flour Mills, Inc., 76 Haw. 1, 7, 868 P.2d 419, 425 (1994) ("The Director [of Taxation] admitted that HRS 237-24[.3(2)(C)] was unconstitutional on its face and argued that it should be severed from the statute."). The Director of Taxation no longer permits any taxpayers to take this exemption. See Hawaiian Flour Mills, Inc., 76 Haw. at 14, 868 P.2d at 432 ("[T]he Director effectively admitted that the exemption was unconstitutional by instructing his staff to administratively sever it from the statute and to disallow any taxpayer from claiming the exemption. ").
42. See HRS § 237-4(8) (Michie 1996) which defines wholesale sales, inter alia, as:  
  
Sales of tangible personal property to a licensed person engaged in the service business; provided that (A) the property is not consumed or incidental to the performance of the services; (B) there is a resale of the article at the retail rate of four per cent; and (C) the resale of the article is separately charged or billed by the person rendering the services[.]
43. Prior Tax Review Commissions have also addressed this issue. The 1984 Tax Review Commission considered three different types of taxes to eliminate the pyramiding of the general excise tax while still maintaining the productiveness of the tax: a retail sales tax,

a non-pyramiding gross receipts tax, and a net excise tax. After analyzing each of these taxes, the 1984 Tax Review Commission decided to recommend no large-scale change. Instead, it recommended adjustments to remove some of the more inequitable aspects of the general excise tax. See 1984 Tax Review Comm'n Rep. 8-9. Because of a concern about pyramiding, the 1989 Tax Review Commission recommended eliminating or minimizing tax pyramiding on interbusiness transactions and multiple lease transactions. See 1989 Tax Review Comm'n Rep. 6.

44. HRS § 237-13(3)(B) (Michie 1996).
45. HRS § 237-18(f) (Michie 1996).
46. HRS § 237-24.3(3) (Michie 1996).
47. HRS § 237-18(a) (Michie 1996).
48. HRS § 237-18(b) (Michie 1996).
49. HRS § 237-18(e) (Michie 1996).
50. HRS § 237-18(f) (Michie 1996).
51. HRS § 237-24.7(1) (Michie 1996).
52. HRS § 237-24.7(4) (Michie 1996).
53. See HRS § 237-13 (Michie 1996) ("There is hereby levied and shall be assessed and collected annual privilege taxes against persons on account of their business and other activities ...."); see also HRS § 237-3 (a) (Michie 1996) ("'Gross income' means the gross receipts, cash or accrued, of the taxpayer received as ... the gross receipts of the taxpayer derived from trade, business, commerce, or sales ... and all receipts, actual or accrued as hereinafter provided, by reason of the investment of capital of the business ....").
54. HRS §§ 237-24.3(3)(A) and 237-24(16) (Michie 1996).
55. HRS § 237-24.3(9) (Michie 1996).
56. HRS § 237-24 (Michie 1996).
57. See Haw. Dept. of Tax., Tax Information Release No. 91-4 (May 15, 1991).
58. See id.
59. See 1989 Tax Review Comm'n Rep. 7.
60. See HRS § 237-23(a)(6), (10) (Michie 1996) (providing that general excise tax is not imposed on receipts of hospitals, infirmaries, and sanitariums if no profit inures to the benefit of any individual and does not apply to receipts from any activity the primary purpose of which is to produce income even though the income is to be used for or in furtherance of the exempt activities of such persons).

61. R. Bock, E. Brilliant, A. Fernandes, *Taxes of Hawaii With Emphasis on Relationship to Federal Income Taxes* 246 (1996).
62. Id.
63. See generally Chapter 238 of the Hawaii Revised Statutes for specific provisions of Hawaii's use tax law.
64. See 1989 Tax Review Comm'n Rep. 7.
65. R. Bock, E. Brilliant, and A. Fernandes, *Taxes of Hawaii With Emphasis on Relationship to Federal Income Taxes* 64 (1996).
66. Id.
67. See 1994-1995 Dep't. of Tax. Ann. Rep. 27.
68. Id.
69. See id. ("Two tax credits intended for lower-income taxpayers are the excise tax credit and the renter's tax credit which may be claimed by residents with adjusted gross income under \$30,000. ... In response to budget considerations, the 1995 legislature repealed the excise tax credit beginning with tax year 1995.").
70. See id.
71. Id.
72. See id.
73. See id. ("The same act repealed the medical services excise tax credit beginning with the 1995 tax year.")
74. See 1994-1995 Dep't. of Tax. Ann. Rep. 14 ("Repeals the medical services excise tax credit but retains the nursing facilities tax credit."); see also HRS § 235-55.9 (Michie 1996) ("The medical services excise tax credit shall be six per cent of the nursing facilities expenses paid by or for the resident individual during the taxable year.").
75. See HRS § 235-55.9(g) (Michie 1996) ("This section shall not be effective after June 30, 1997.").
76. HRS § 235-51(f)(B) (Michie 1996).
77. See HRS § 235-5 (Michie 1996) (regarding allocation of income of persons not taxable upon entire income).
78. R. Bock, E. Brilliant, A. Fernandes, *Taxes of Hawaii With Emphasis on Relationship to Federal Income Taxes* 69 (1996); see HRS § 235-54 (Michie 1996) (providing "A nonresident shall be entitled to the same personal exemptions as a resident, without proration of the personal exemptions on account of income from sources outside the State.").

79. See HRS § 235-2.4 (Michie 1996) (providing the standard deduction amounts).
80. See R. Bock, 1994 Guidebook to California Taxes 201 (1993) ("Nonresidents are taxed as though they were residents but with the tax computed according to the ratio of California-adjusted gross income to total income.").
81. This method would require nonresidents to take their federal taxable income, as modified to reflect applicable state law ("MFTI"), multiply that by the appropriate tax rate ("R") and multiply that product by the fraction with a numerator of which is state source adjusted gross income ("HAGI") and a denominator of which is federal adjusted gross income modified to reflect applicable state law ("MFAGI") to arrive at the net income tax due to Hawaii ("HT"). The proposed method of taxation can be illustrated by following formula:

$$HT = (HAGI/MFAGI) (X) R (X) MFTI.$$

82. Currently, nonresidents pay tax calculated by taking their Hawaii source income and subtracting certain deductions to arrive Hawaii taxable income. Taxable income is then multiplied by the appropriate tax rate to arrive at the net income tax due to Hawaii. The current method of taxation can be illustrated by the following formula:  $TAX = R (X) HTI$ . See HRS § 235-5 (Michie 1996) (regarding allocation of income of persons not taxable upon entire income).
83. HRS § 235-2.4(l) (Michie 1996) provides:

Section 1034 (with respect to rollover of gain on sale of principal residence) of the Internal Revenue Code shall be operative for the purpose of this chapter; provided section 1034(a) (with respect to nonrecognition of gain) of the Internal Revenue Code shall apply only to:

- (1) A taxpayer who purchases a replacement residence which is located within the State;
- (2) A taxpayer who is a resident of the State, taxable upon the taxpayer's entire income, computed without regard to source within the State; or
- (3) A taxpayer (or the taxpayer's spouse if the old residence and the new residence are each used by the taxpayer and the taxpayer's spouse as their principal residence) who, while serving on extended active duty with the armed forces of the United States, purchased a residence in Hawaii and later sold the residence.

84. See id.
85. See id.
86. See HRS § 235-7(a)(7) (Michie 1996).

87. See HRS § 235-7(g) (Michie 1996).
88. See HRS § 235-5.5 (Michie 1996).
89. See HRS § 235-55.9 (Michie 1996).
90. See HRS § 235-55.8 (Michie 1996).
91. See HRS § 235-55.6 (Michie 1996).
92. 1989 Tax Review Comm'n Rep. 30.
93. 1984 Tax Review Comm'n Rep. 6.
94. 1989 Tax Review Comm'n Rep. 30.
95. Id.
96. See 1984 Tax Review Comm'n Rep. 6. For a further discussion on the advantages and disadvantages of different types of stabilization funds, see the 1989 Tax Review Commission Report pages 30 to 33.

APPENDIX A

**REVENUE STATISTICS, BURDEN, AND REVENUE ADEQUACY**

**1. State and Local Revenue Statistics**

State and local general revenues (combined) derive from three sources: federal intergovernmental transfers, own source taxes, and own source charges. In fiscal year 1993, Hawaii state and local government general revenues amounted to \$6.028 billion, 18% from the federal government and 82% from own sources. Taxes accounted for 58% of all general revenues, roughly the same as the average share among the states in the U.S.

Table A-1. General Revenues, State and Local Government Combined (FY 1993)

<u>Source</u>	<u>Hawaii % of Total</u>	<u>U.S. Average % of Total</u>
Federal Government	18%	19%
Own Source	82%	81%
Taxes	58%	57%
Property	10	18
General Excise	22	13
Income	16	14
Other	10	11
Charges	24%	24%

Data: U.S. Department of Commerce, Bureau of the Census, <http://www.census.gov>, May 1996.

Compared with other states, excise or sales taxes make up a larger share (38% v. 24%) of combined state and local government tax revenues in Hawaii. Only three states (Washington, Tennessee and New Mexico) had greater reliance on the sales tax in FY 1992. By contrast, real property taxes in Hawaii make up a much smaller share (16% v. 32%) of state and local government revenues. Four states (Alabama, New Mexico, Delaware and Oklahoma) had a lower reliance on property taxes.<sup>1</sup>

A separation of state revenues from local revenues shows the relative dependence of the State and the counties on each of the sources. Hawaii State and county governments derive more

of their revenues from their own sources, in comparison to other state and county governments. For the State, this is largely due to the heavier reliance on general sales taxes as well as charges. For the counties, this is largely due to a heavy reliance on real property taxes. Hawaii counties also appear to have a much less diversified revenue base than do their counterparts in the other states.

Table A-2. General Revenues, State and Local Government Separate (FY 1993)

<u>Source</u>	<u>Hawaii</u>		<u>U.S.</u>	
	<u>State</u>	<u>Local</u>	<u>State</u>	<u>Local</u>
Federal Government	21%	7%	27%	4%
State & Local	0%	13%	2%	34%
Own Source	79%	80%	71%	62%
Taxes	57%	53%	54%	39%
Property	0	44	1	30
General Sales	27	0	17	4
Income	20	0	21	2
Other	10	9	15	3
Charges	22%	26%	17%	23%

Data: U.S. Department of Commerce, Bureau of the Census, <http://www.census.gov>, May 1996.

## 2. Brief Summary of Hawaii's Tax System

The general excise tax comprises the largest part of the State of Hawaii's general fund tax revenue.<sup>2</sup> The individual net income tax comprises the second largest part of the State's general fund tax revenue.<sup>3</sup>

In total, Hawaii has eighteen separate tax laws of which fifteen are administered by the State.<sup>4</sup> The counties administer the remaining three tax laws - the motor vehicle weight tax, the public utility franchise tax and the real property tax.<sup>5</sup> The counties also administer the State motor vehicle weight tax, revenues from which accrue to the State highway fund.<sup>6</sup>

Revenues from eleven of the State-administered taxes go into the State's general fund and are used to provide the various services of State government, including public education which is a state function in Hawaii.<sup>7</sup> Although administered by the State, the fuel tax is a dedicated tax for the benefit of county highway funds and State highway, airport and boating special funds.<sup>8</sup> The employment security tax is used exclusively to provide benefits to unemployed workers.<sup>9</sup> Rental motor vehicle and tour vehicle surcharge taxes accrue to the State highway fund.<sup>10</sup> Revenue from the nursing facility tax is deposited into the health care revolving fund.<sup>11</sup>

### **3. Tax Burden**

In this section, the Commission addresses public commentary related to tax burdens and the level of taxes in Hawaii. The Commission notes that any comparison of Hawaii's taxes with those of other states requires a comparison of combined state and local taxes. Comparisons would otherwise be meaningless, because of the wide variation in the allocation of functions between state and local governments elsewhere and the wide variation in reliance on particular forms of revenue.

In 1993, Hawaii's state and local taxes amounted to \$2,984 per capita, ranking 6th among the states and 30% higher than average per capita taxes for the U.S. as a whole. In the same year, Hawaii's state and local taxes as a percent of personal income was 12.7%, ranking 6th among the states and 22% higher than the U.S. average.

Other sources of comparative data suggest differing degrees to which Hawaii taxes exceed those in other states, depending on the methodology used. A compilation by the Tax Foundation reports Hawaii's overall tax burden to be 14.1% compared to a U.S. average of 11.5%.<sup>12</sup> A 1991 report by Citizens for Tax Justice compares tax burdens by income group. For example, a family of four in Hawaii with an income of \$88,700 has a state and local tax burden of 8.5% of income, compared to a family of four elsewhere in the U.S. with an income of \$82,200 and a tax burden of 7.7%. A 1992 report from the D.C. Department of Finance shows that both Hawaii and U.S. families of four earning \$75,000 have roughly identical state and local tax burdens of 9.7% of income.

Measures of tax burden, like those above, are not precise. A true measure of tax burden must account for the incidence of the tax--that portion of a tax borne by the buyer and the seller in any transaction. In Hawaii's case, a large proportion of Hawaii's taxes are likely to be exported to nonresidents.

A 1989 analysis estimated that approximately one quarter of Hawaii's taxes was exported to nonresidents. That study measured the burden of taxes paid by Hawaii residents, after accounting for state and local taxes passed on to the federal government and taxes exported to nonresidents.<sup>13</sup> If the amount of taxes per capita were simply reduced by 25% to account for exporting, Hawaii taxes would still be higher than the U.S. average. However, lack of comparable data for other states, as well as the lack of data on tax importing, make it difficult to measure and compare actual state and local tax burdens in any precise manner.



TABLE A-3

A number of changes in Hawaii's tax law that post date the 1989 burden study are likely to reduce the extent to which Hawaii's taxes are exported. This is primarily due to the repeal or reduction of certain net income tax credits (excise, food, medical services excise). Combined new taxes (rental motor vehicle surcharge, environmental response, hospital and nursing facility) or increases in existing ones by base or rate change (conveyance, transient accommodations (TAT), financial institutions, liquor, tobacco) may work to increase the proportion of taxes exported. According to the 1989 study, nonresidents pay a large, but minority, share of the conveyance, financial institutions, liquor, and tobacco taxes. They are likely to pay almost all of the rental motor vehicle surcharge and the increase in the TAT. Exported amounts generated by these changes are unlikely to outweigh the increased resident burden created by the repeal of the excise tax credits, however.

The Miklius study also measured the burden of Hawaii's state and local taxes by income class. The analysis showed that Hawaii's tax structure is mildly regressive when compared to the average state and local tax structure in the U.S., largely due to the regressivity of the general excise tax. The tax changes identified above are likely to increase the regressivity of Hawaii's tax structure, because of the larger effects of the various net income tax credit repeals.

#### **4. Revenue Adequacy**

The Commission believes that revenue adequacy of the State government's tax system is not an outstanding issue. Taxes generate adequate revenues.

Revenue adequacy measures the sufficiency of revenues (tax and nontax) to provide a given level of service **over time**. Revenues are adequate if long run revenue growth is equal to planned expenditure growth.

Long run revenue adequacy does not imply that revenue shortfalls never occur. Shortfalls can occur during recessions when tax revenues dip and income maintenance expenditures increase. However, these are balanced by rising revenues and falling income maintenance expenditures during economic expansions. From a fiscal management perspective, long run balance is achieved if revenues accumulated during economic expansions are withheld to offset shortfalls occurring during economic recessions.

The State has a fiscal system which provides for long run revenue adequacy. The 1978 Constitution requires that expenditures grow no faster than the economy, a requirement made operational by the establishment of a spending ceiling (Act 277). The Constitution also permits the Legislature to exceed the spending limit by two-thirds majority vote of each house. This allows the Legislature to appropriate less than the spending ceiling in some years and more than the spending ceiling in other years, drawing on accumulated balances in the general fund and maintaining stable program spending. Finally, the tax structure is income elastic -- tax revenue changes are proportionally larger than income changes, so that tax revenues rise faster than

income during economic expansions.

Thus, fiscal balance is maintained so long as: (1) the spending ceiling accurately reflects long run ability of the economy to support that level of spending; (2) there are sufficient balances in the general fund or in a stabilization fund to cover most periods of revenue shortfall. In practice, the requirements for fiscal balance have not been attained.

1. The spending ceiling (Act 277) has outstripped both revenues and expenditures, ceasing to be an effective guide for spending. The accompanying chart shows that actual and projected revenues, beginning in FY 1995, are approximately \$625 million below the expenditure ceiling.

The spending ceiling only reflects economic changes with a lag, because the ceiling is calculated on a ceiling-to-ceiling basis, using the average of personal income growth for the past three years. Cyclically high personal income growth into the early 1990's boosted the spending ceiling to a level higher than one consistent with trend growth in the economy. The spending ceiling is projected to remain high relative to revenues, until economic growth accelerates substantially.

2. The general fund balance is significantly below the balances opening the decade of the 1990's. Over the three year period from FY 1989 to FY 1992, the general fund balance declined from a high of \$629 million (26% of revenues and 28% of expenditures) to \$374 million (roughly 14% of both revenues and expenditures). In two of these years, expenditures exceeded the spending ceiling, even though this was not a period of economic decline in Hawaii. During this period as well, earmarking of general fund taxes diverted revenues from the general fund into special funds (educational facilities improvement special fund). This depletion of the general fund balance did not reflect a need to achieve stable spending in the face of falling revenues.

GENERAL FUND CHART

TABLE A-4  
GENERAL FUND REVENUES AND EXPENDITURES

**Tax Revenue Adequacy Methodology.** This Commission examined general fund tax revenue adequacy, using the methodology developed by Mak and Ahmad.<sup>14</sup> The following is a summary of their reasoning:

- Expenditures can grow no faster than the economy, by constitutional mandate. The rate of growth of maximum allowable spending is measured by the rate of personal income growth.
- Revenues, both tax and nontax, will be adequate, provided that the rate of revenue growth is the same as the rate of personal income growth. This implies a required income elasticity of 1.0 for total tax and non tax revenues.

Table A-5 shows that the total of general fund tax revenues is income elastic -- tax revenue totals grow 3% faster than personal income. Elasticity estimates of general fund tax revenues show an apparent decline over time, although results are not strictly comparable due to periodic revisions of personal income by the U.S. Bureau of Economic Analysis. It also presents estimates of income elasticity for various taxes that accrue to the general fund. The data was adjusted to reflect the productiveness of each tax. That is, net income tax revenues include constitutionally mandated rebates, general excise tax revenues include amounts earmarked for special funds, and insurance and liquor tax revenues include amounts deposited into escrow accounts.

In the absence of information regarding the expected growth of nontax revenues, Mak and Ahmad (1989) reasoned that if nontax revenues do not grow at all and if nontax revenues make up 10% of general fund revenues, then revenue adequacy requires that the income elasticity of general fund tax revenues be approximately 1.10 -- that general fund tax revenues need to grow 10% faster than personal income. Their elasticity findings confirmed this result.

This Commission did not obtain estimates of the income elasticity of nontax revenues, but reasoned that nontax revenues are likely to be somewhat related to personal income changes, so that the responsiveness of nontax revenues to personal income is larger than zero. Moreover, nontax revenues comprised a slightly higher proportion (92%) of general fund tax revenues in FY 1994, placing less of a requirement on tax revenues to make up the difference.

Table A-5 General Fund Tax Income Elasticities

APPENDIX A  
ENDNOTES

1. See ACIR, Significant Features of Fiscal Federalism, Vol. 2 (1994).
2. See 1994-1995 Dep't. of Tax. Ann. Rep. 27 ("The general excise tax continues to be the major source of the state's general fund tax revenue, followed by the progressive individual income tax.").
3. See id.
4. Id.
5. Id.
6. See id.
7. Id.
8. See id. ("Although the fuel tax is administered by the state, it is a source of revenue for both state and county governments.").
9. Id.
10. Id.
11. Id.
12. See Forbes, "It's the costs, stupid," Oct. 21, 1996 pp. 252-258.
13. See Miklius, Moncur & Leong, "Distribution of State and Local Tax Burden by Income Class," Tax Review Commission Working Papers and Consultant Studies, Vol. 2 (1989).
14. See "Is Hawaii's Tax System Adequate?," Tax Review Commission Working Papers and Consultant Studies, Vol. 2 (1989).



## APPENDIX B

### **COUNTY REVENUES**

As noted elsewhere in this report, the Commission explicitly decided to limit the scope of its work and to limit the extent of its budget requests, in consideration of the then current and projected financial position of State government. County revenue issues happened to be one set of issues the Commission did not investigate. Such an investigation would require an examination of functions performed by the State and the counties. It would also require the identification of appropriate revenue sources under the principle that the provider of the service should also be the one responsible for raising the revenues to pay for it.

In 1989, the Advisory Commission on Intergovernmental Relations recommended a realignment of service responsibilities and some shifts in revenue raising authority, primarily so that a single level of government is responsible for providing any given public service.<sup>1</sup> A recent comparison of expenditure shares by Hawaii state and counties with their counterparts in the rest of the U.S. suggests that little realignment has occurred.

There continues to remain a dilution of responsibilities, as well as substantial differences in the state/local alignment of functions between Hawaii and other states. Hawaii has a highly centralized government, and the State is responsible, in part, for many functions typically performed by local governments elsewhere.

In fiscal year 1993, State spending accounted for 78% of combined state/local general government expenditures. The average for state government spending among the fifty states is 44%. Most notably, elementary and secondary education in Hawaii is entirely the State's responsibility, in contrast to the case in other states. Even if direct spending on education were to be shifted from the State to the counties, the State share of total spending would be 65%. The accompanying Table B-1 shows that Hawaii state government's share is larger than the U.S. average for all of the selected functions.

The difference in functional alignment is reflected in a difference in revenue structure. Table B-2 shows that in fiscal year 1993, State tax revenues accounted for 79% of all state/local tax revenues compared to a U.S. state average of 59.7%. This is the result of higher than average State general sales tax and public utility tax shares and, to a lesser degree, higher State income, alcohol and tobacco tax shares. Only in the case of fuel taxes and motor vehicle licensing were State shares smaller than the U.S. average. Property taxes remain the primary domain of local governments in both Hawaii and the rest of the states.

Table B-1. State and Local Spending Shares for Selected Functions  
Hawaii and U.S. Average (1993)

<u>Function</u>	Hawaii		U.S. Average	
	<u>State</u>	<u>Local</u>	<u>State</u>	<u>Local</u>
General Expenditure	78%	22%	44%	56%
Education				
Elementary&Secondary	100	0	1	99
Higher	100	0	84	16
Welfare	98	2	82	18
Hospitals	100	0	44	56
Highways	83	17	62	38
Housing	50	50	10	90
Government Admin.	57	43	40	60

Data: U.S. Department of Commerce, Bureau of the Census. <http://www.census.gov>, May 1996.

Table B-2. State and Local Shares of Selected Tax Revenues  
Hawaii and U.S. Average (1993)

<u>Tax Source</u>	Hawaii		U.S. Average	
	<u>State</u>	<u>Local</u>	<u>State</u>	<u>Local</u>
All Taxes	79%	21%	60%	40%
Property Tax	0	100	4	96
General Sales Tax	100	0	83	17
Motor Fuel Tax	57	43	97	3
Alcoholic Beverage	100	0	93	7
Tobacco	100	0	97	3
Public Utility	80	20	58	42
Individual Income	100	0	91	9
Corporate Income	100	0	92	8
Motor Vehicle License	64	36	93	7

Data: U.S. Department of Commerce, Bureau of the Census. <http://www.census.gov>, May 1996.



In this section, the Commission addresses public commentary related to the following county revenue items: the real property tax, the transient accommodations tax, and sharing of the general excise tax.

## **1. Real Property Taxes**

Real property taxes in Hawaii generate a smaller proportion of state and local taxes than in most other states, albeit in part due to the provision of certain government services such as public education by the State rather than the counties.

In its 1989 study, the ACIR suggested that the property tax was significantly under used, while income and sales taxes were used substantially more than the average for other states in the U.S. It further indicated that any shifts in taxing authority should be in the direction of increased reliance on the property tax and reduced reliance on income and sales taxes. It also suggested means of property tax relief that required coordination with the State.<sup>2</sup>

Property tax revenues in Hawaii are responsive to economic conditions, through changes in real property valuations, and have grown at an average annual rate of 9.8% for all counties combined between 1980 and 1994. Growth rates range from 8.8% per year for the City and County of Honolulu to 15.1% per year for Maui county. Still, per capita property tax revenues and burdens are lower than the U.S. average and an average of western U.S. states (Alaska, California, Nevada, Oregon, Washington).<sup>3</sup>

In 1989, the counties received final authority over the property tax, including rate setting, tax classifications, and assessment. Since then, the counties have used this authority in varying fashions. Rates were generally decreased in all counties. Residential homeowners appear to be the primary beneficiaries in terms of rate reduction, receiving substantially reduced rates in Honolulu, special homeowner classification at reduced rates in Maui and Hawaii, and residential rate reduction and a special homestead classification in Kauai.<sup>4</sup>

The Commission takes no position on the property tax, except to note that the counties might need to revisit their rate reduction decisions, if revenues are not adequate to cover planned spending, since the availability of additional State funds from the Legislature is not assured.

## Real Property Tax Collections Graph

## **2. Transient Accommodations Tax (TAT)**

**a. Disposition of the TAT.** The 1989 ACIR report recommended that this tax be turned over to the counties, because its incidence is primarily on the visitor. Under the benefit principle of taxation, this tax was deemed to be well suited for financing the county-provided public services for which visitors are beneficiaries.

The State Legislature (Act 185, SLH 1990) provided that 95% of transient accommodations tax revenues be distributed to the counties as a state grant. By designating the revenues as grants-in-aid, the Legislature deferred on the issue of turning the TAT over to the counties.

The Commission takes no position on the disposition of the TAT.

**b. Rate of the TAT.** The rate of the TAT is 6%, with 1% earmarked for the convention center capital and operations special fund, to be used for construction and debt service on revenue bonds issued by the convention center authority. When combined with the general excise tax levied on room rentals, the effective tax rate is 10.16%. This rate of taxation is below the average rate of 12.03% for 50 major U.S. cities, but close to the average rate of 10.80% for resort destinations.<sup>5</sup> The effective rate of the TAT was increased from 9.16% to 10.16%, as of July 1, 1994, reflecting an increase in the rate of the TAT from 5% to 6%.

The Commission believes that raising the TAT rate is not appropriate at this time. Hawaii's TAT is quite close to effective lodging tax rates in destinations which might be considered competitive for the resort dollar. This basis for comparison is appropriate, although it could be revisited if the share of business travel to Hawaii becomes substantial.

## **3. Sharing the General Excise Tax**

According to the 1989 ACIR report, such a shared tax is really an unconditional grant-in-aid, financed by earmarking a portion of the proceeds of the general excise tax. In general, making such grants reduces the accountability of the spending jurisdictions--the counties in this case. On the other hand, such grants may be necessary to close the gap between the cost of providing (statewide) average levels of services and the revenues that a county can raise if its revenue system were as productive as the average system of all the counties.<sup>6</sup>

The Commission takes no position on general excise tax sharing. Using this mechanism of diversifying county revenues requires a judgment on (1) whether the improvement in horizontal equity is worth the loss of accountability and (2) whether some other tax vehicle might not be more appropriate.

APPENDIX B  
ENDNOTES

1. See ACIR, “Intergovernmental Fiscal Relations in Hawaii,” Tax Review Commission Working Papers and Consultant Studies (1989).
2. See ACIR, “Intergovernmental Fiscal Relations in Hawaii,” Tax Review Commission Working Papers and Consultant Studies p. 148 (1989).
3. See ACIR, Significant Features of Fiscal Federalism (1994).
4. See DBEDT Data Book 1989 pp. 271, 274 (1995).
5. See USTDC/TIA, Travel Taxes in America’s Top Destinations, Jan. 1996.
6. See ACIR, “Intergovernmental Fiscal Relations in Hawaii,” Tax Review Commission Working Papers and Consultant Studies pp. 150-151 (1989).