

Appendix E

**Letter dated August 8, 2002 from the Tax Foundation of Hawaii
to the Tax Review Commission**

August 8, 2002

Tax Review Commission
State of Hawaii
P. O.Box259
Honolulu, Hawaii 96809

Dear Ladies & Gentlemen:

We are aware that the Tax Review Commission is undertaking its constitutionally mandated review of the state's tax system and structure with a mandate to recommend tax and revenue policy. We submit the following observations and concerns for consideration by the current Commission in its deliberation of how the state's tax system can be improved insofar as equity and efficiency as well as level of tax burden imposed.

1. Increase threshold for maximum income tax rate. Although the state personal income tax rates were reduced as recently as 1998, albeit phased-in over a period of four years with the final phase kicking in this year, we believe that Hawaii's tax rates are still amongst the highest in the nation where the maximum tax rate is imposed at rather modest income levels. We believe that the maximum rate should be imposed on six figure incomes just as a matter of perception. And where possible consider reducing income tax rates further.

2. Increase the standard deduction. We also believe that nothing was done in the 1998 effort to adjust income tax rates and brackets to address those at the lower levels of income. The standard deduction has not been increased in over a decade. As a result, Hawaii has the third lowest threshold before the net income tax begins to be imposed. Not only does this impose an undue hardship on lower-income individuals and families, but it keeps larger numbers of individuals on the tax rolls. The standard deduction should be increased.

3. Provide for equity in the treatment of "retirement income." As baby boomers age and begin to retire, there will be a growing disparity between those who receive traditional types of pension income and those who have contributed to the plethora of new vehicles for retirement income including those who participate in 401(k) plans, SEP's, and Individual Retirement Accounts. Under current law, disbursement from traditional pension plans, such as a defined benefit plan, would be exempt from taxation under state income tax laws while those who realize retirement income from any one of the newer types of retirement strategies will find their disbursements subject to taxation under the state income tax laws. Consideration must be given to

either taxing all types of retirement income or exempting all such income. Under current law, there is inequitable treatment of what should be considered retirement income.

4. Review current menu of tax credits and set criteria. In recent years, lawmakers have spawned a spate of income tax credits designed to modify human behavior. Disguised as economic development incentives, these credits have no bearing or relationship to the tax burden imposed and therefore amount to nothing more than a subsidy of certain industries or activities. The ultimate result is to shift the burden of taxes from those favored with such tax credits to those not so favored. As a result, the base of the income tax is eroded by such special interest tax credits at the expense of all taxpayers who must continue to pay the high burden of taxes. Thus, lawmakers have been precluded from doing what needs to be done to expand the economic base of the state and that is to improve the investment and business climate of the state. The improvement of the investment and business climate is critical to attracting new capital to the state to create the jobs needed by Hawaii's people. We believe the Commission should review and evaluate the current spate of income tax credits and establish criteria against which these credits and all future proposals for income tax credits should be measured with respect to appropriateness to alleviating the tax burden imposed.

5. Revise or re-write the capital goods excise tax credit. While on the subject of credits, there is a current credit that was designed to alleviate the cost of acquiring capital goods which has long been acknowledged to be crucial to the creation of jobs. Originally patterned after the federal investment tax credit with references to the definitions underlying the federal credit, those provisions are now difficult to access since the federal credit has long been repealed. As a result, administration and compliance with the provisions of the capital goods excise tax credit have been less than forthright. A recent interpretation of the credit has resulted in applications that appear to have strayed from the original intent and understanding of the credit as a mirror of the federal credit. It would seem that the credit needs to be revised or rewritten as a whole to provide contemporary definition of terms and provisions which currently rely on outdated federal law and to clarify how and to what the credit applies.

6. Reduce or eliminate the corporate income tax rates. Reduction or elimination of the corporate income tax rate should also be considered by the Commission. Given the fact that the corporate income tax contributes so little and its corollary, the financial institutions franchise tax resulted in a negative collection last year, both mean little to the state insofar as financial resources. However, we also recognize that there cannot be an identical reduction in the nominal rates since the financial institutions franchise tax is in-lieu of the net corporate income tax and the general excise tax. But a concurrent reduction in the rates of both taxes will go a long way toward improving the attractiveness of Hawaii as a place to invest and do business.

7. Treatment of capital gains income should mirror the federal treatment. The last time the issue of capital gains taxation was addressed was in 1987 when the rate was set at 7.25% at a time when the federal law applied ordinary income tax rates to capital gains. Since that time reduction in the personal income tax rates has lowered the top tax rate to 8.25%. During the same period, the federal law was changed to extend lesser tax rates on capital gains to those in lower income categories and extended lower rates for gains realized from assets held for longer periods of time. Consideration should be given to lowering the maximum capital gains tax rate and setting alternative lower rates for lower income individuals.

8. Review the use of user fees and charges as in-lieu taxes. Finally, with the shift in dependence for financing government operations away from the general fund to special finds, we believe it imperative that the Commission examine the use of user fees and charges as a substitute for taxes in recent years. As a result, evaluating the tax burden on the people of Hawaii should also take into account the imposition of user fees and charges as substitutes for tax increases.

We appreciate your request for our comments and observations and stand ready to explain or expand on our comments on the foregoing observations.

Sincerely,


Lowell L. Kalapa
President