

EFFECTS OF ELIMINATING THE HAWAII INDIVIDUAL INCOME TAX FOR TAXPAYERS WITH INCOME BELOW POVERTY LEVEL

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I. Introduction

The 2010-2013 Tax Review Commission requested an analysis of the potential revenue impact of eliminating individual income tax for taxpayers with income below poverty level. This paper examines the impact of eliminating individual income tax for those below poverty level by:

1. Determine who is in poverty;
2. Determine who pays Hawaii's individual income tax;
3. Determine current tax reliefs for the poor; and
4. Determine the potential revenue impact of eliminating individual income tax for those below poverty level.

II. Who Is In Poverty?

There are two versions to measure poverty used by Federal government: (1) poverty thresholds and (2) poverty guidelines.

Poverty Thresholds

Poverty thresholds are the original version to measure poverty. They are updated each year by the United States Census Bureau ("Census Bureau"). The Census Bureau measures poverty by "money income" that varies by family size and composition. "Money income" includes "earnings, unemployment compensation, workers' compensation, Social Security, Supplemental Security Income, public assistance, veterans' payments, survivor benefits, pension or retirement income, interest, dividends, rents, royalties, income from estates, trusts, educational assistance, alimony, child support, assistance from outside the household, and other miscellaneous sources." It is before taxes and does not include capital gains or noncash benefits such as public housing, Medicaid, and food stamps. The poverty thresholds as defined by the Census Bureau do not vary by geographical area¹. Table 1 shows poverty thresholds for 2011.

¹ Source: U.S. Census Bureau, <http://www.census.gov/hhes/www/poverty/about/overview/measure.html>

Table 1. Poverty Thresholds for 2011 by Size of Family and Number of Related Children Under 18 Years

Size of Family Unit	Weighted Average Thresholds	Related children under 18 years								
		None	One	Two	Three	Four	Five	Six	Seven	Eight or more
One person	11,484									
Under 65 years	11,702	11,702								
65 years & over	10,788	10,788								
Two people	14,657									
Householder under 65 years	15,139	15,063	15,504							
Householder 65 years & over	13,609	13,596	15,446							
Three people	17,916	17,595	18,106	18,123						
Four people	23,021	23,201	23,581	22,811	22,891					
Five people	27,251	27,979	28,386	27,517	26,844	26,434				
Six people	30,847	32,181	32,309	31,643	31,005	30,056	29,494			
Seven people	35,085	37,029	37,260	36,463	35,907	34,872	33,665	32,340		
Eight people	39,064	41,414	41,779	41,027	40,368	39,433	38,247	37,011	36,697	
Nine people or more	46,572	49,818	50,059	49,393	48,835	47,917	46,654	45,512	45,229	43,487

Source: U.S. Census Bureau.

Poverty Guidelines

The poverty guidelines are updated each by the United States Department of Health and Human Services (“DHS”). The poverty guidelines simplified the poverty thresholds for administrative purposes, that is, to determine eligibility for certain federal programs, such as Special Supplemental Nutrition Program for Women, Infants, and Children, Low-Income Taxpayer Clinics, Legal Services for the Poor, Children’s Health Insurance Program, and Job Opportunities for Low-Income Individuals.

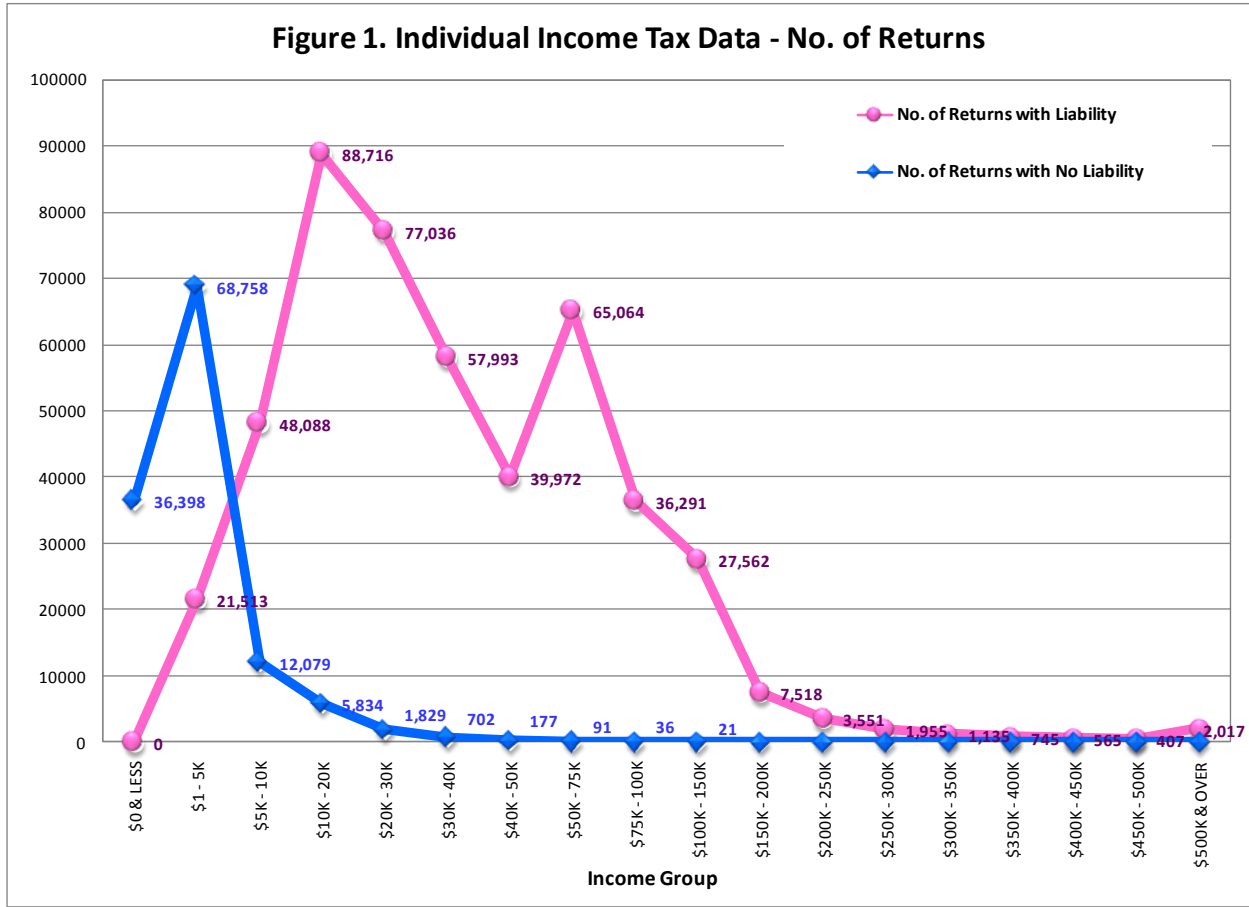
Beginning in the late 1960s, the DHS distinguishes Alaska and Hawaii from the 48 contiguous states. Table 2 shows the poverty guidelines for 2012²:

Persons in Family/Household	48 Contiguous States and the D.C.	Hawaii	Alaska
1	\$11,170	\$12,860	\$13,970
2	\$15,130	\$17,410	\$18,920
3	\$19,090	\$21,960	\$23,870
4	\$23,050	\$26,510	\$28,820
5	\$27,010	\$31,060	\$33,770
6	\$30,970	\$35,610	\$38,720
7	\$34,930	\$40,160	\$43,670
8	\$38,890	\$44,710	\$48,620
For families with more than 8 persons, add:	\$3,960/additional person.	\$4,550/additional person.	\$4,950/additional person

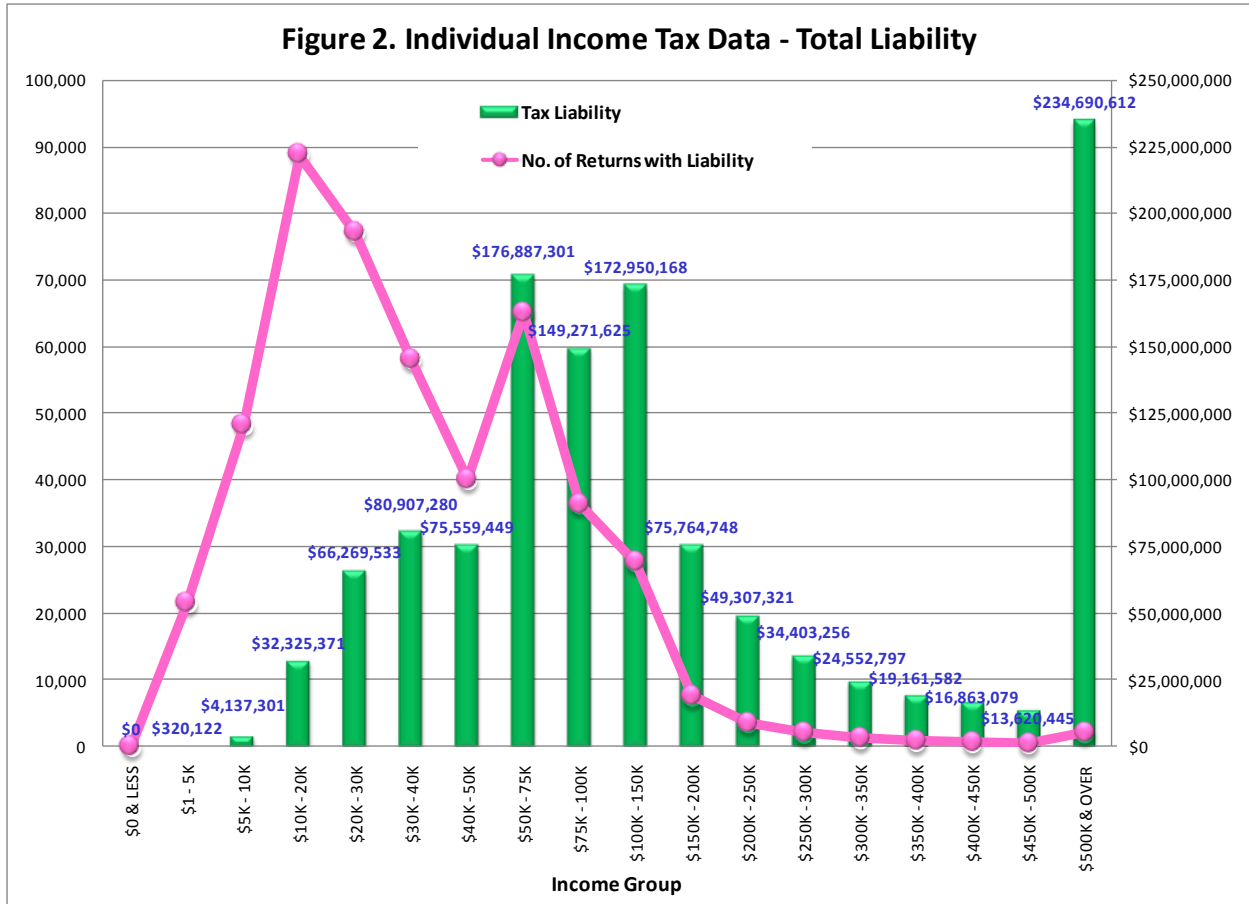
² Source: U.S. Department of Health and Human Services, <http://aspe.hhs.gov>

III. Who Pays Hawaii Individual Income Tax?

In 2004, for than 600,000 individual income tax returns were filed, with 61% (about 370,000) of returns with tax liability and 39% (230,000) with no tax liability (before applying any tax credits) (see Figure 1).

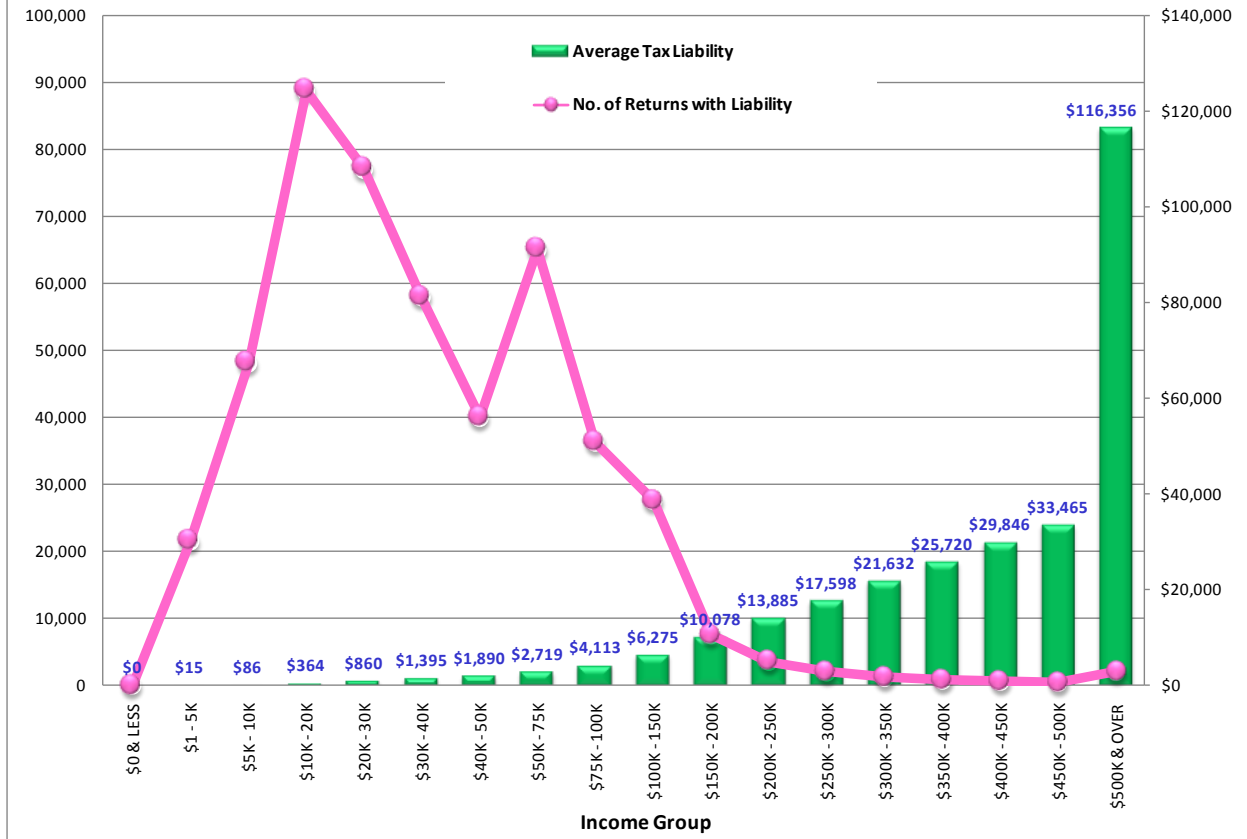


The total liability was \$1.2 billion. Although taxpayers with Hawaii adjusted gross income (“HAGI”) of under \$50,000 represents a majority (60%) of the number of returns with tax liability, and taxpayers with HAGI of \$50,000 or more represents a minority (40%) of the number of returns with liability, of the \$1.2 billion tax liability, only 20% (\$241.9 million) was borne by taxpayers with HAGI of under \$50,000, and 80% (\$967.4 million) was borne by taxpayers with HAGI of \$50,000 or more (see Figure 2).



The average tax liability within the various income groups ranges from \$9 (for those with HAGI of \$1,000 to \$5,000) to \$116,000 (for those with HAGI of \$500,000 or more) (see Figure 3). This shows that Hawaii’s individual income tax is a progressive tax. The more one makes, the more one pays.

Figure 3. Individual Income Tax Data - Average Liability



IV. Tax Credits for the Poor

Hawaii provides reliefs to the taxpayers on the lower income level in the forms of income tax credits such as the refundable food/excise tax credit³ and the income tax credit for low-income household renters⁴ to taxpayers making below certain income level.

Food/Excise Tax Credit

The food/excise tax credit is a graduated amount based on income level, which is determined by the FAGI, and the number of qualified exemptions (see Table 3). The credit is a refundable credit which means that the taxpayers do not need to have a tax liability to claim the credit. A family of five with FAGI under \$5,000, for example, is entitled to a food/excise tax credit of \$425. If this family of five does not have any income tax liability, they will receive a refund of \$425.

³ Act 211, Session Laws of Hawaii (SLH) 2007, replaces the low-income refundable tax credit with the refundable food/excise tax credit and increases the amount of the credit.

⁴ Act 15, SLH 1977, establishes the income tax credit for low-income renters. The amount of the credit was \$20 per qualified exemption for each taxpayer with an adjusted gross income of less than \$20,000.

Table 3. Food/Excise Tax Credit					
Federal AGI	Tax Credit Amount for Households of:				
	1	2	3	4	5
Under \$5,000	\$85	\$170	\$255	\$340	\$425
\$5,000 - \$10,000	\$75	\$150	\$225	\$300	\$375
\$10,000 - \$15,000	\$65	\$130	\$195	\$260	\$325
\$15,000 - \$20,000	\$55	\$110	\$165	\$220	\$275
\$20,000 - \$30,000	\$45	\$90	\$135	\$180	\$225
\$30,000 - \$40,000	\$35	\$70	\$105	\$140	\$175
\$40,000 - \$50,000	\$25	\$50	\$75	\$100	\$125
\$50,000 and over	\$0	\$0	\$0	\$0	\$0

Low-Income Household Renters' Credit

The credit for low-income household renters (“renter’s credit”) is \$50 per qualified exemptions, provided that each taxpayer 65 years of age or over may claim double the tax credit (see Table 4). The credit is limited to taxpayer with HAGI of under \$30,000⁵. The credit for low-income household renters has not been adjusted for twenty two years.

An elderly couple, both over age 65, who rents, with a HAGI under \$30,000, for example, is entitled to a renter’s credit of \$200. If this elderly couple does not have any income tax liability, they will receive a refund of \$200. A family of five with HAGI under \$30,000, who rents, for example, is entitled to a renter’s credit of \$250. If this family of five does not have any income tax liability, they will receive a refund of \$250.

Table 4. Renter's Credit					
Hawaii AGI	Tax Credit Amount for Households of:				
	1	2	3	4	5
Under \$30,000	\$50	\$100	\$150	\$200	\$250

⁵ Act 230, SLH 1981, increases the amount of the low-income renter’s credit to \$50 per qualified exemption. Act 321, SLH 1989, increases the income threshold for the low-income renters credit to less than \$30,000. Act 98, SLH 1990, makes the credit refundable (provides the credit to resident taxpayer who has no income or no taxable income).

V. Estimating the Potential Revenue Impact of Eliminating Individual Income Tax for Those in Poverty

Data and Methodology

The exercise of estimating the potential revenue impact of eliminating individual income tax for those in poverty is accomplished by using historical tax data and applying simulation to the data.

Poverty guidelines rather than poverty thresholds were used to determine those in poverty level as the guidelines distinguish Hawaii from the 48 contiguous states.

Both Federal adjusted gross income and Hawaii adjusted gross income are used to determine income level. FAGI excludes cost-of-living allowances (COLA) for federal employees, contributions to the State employees' retirement system (ERS), and interest on out-of-state bonds, whereas Hawaii adjusted gross income includes those income. HAGI excludes certain pensions, social security benefits, first \$5,881 of military reserve or Hawaii national guard duty pay, payments to an individual housing account and other subtractions from Federal adjusted gross income (see Table 5). Therefore, it is determined that to capture the proper income level, both Federal and Hawaii adjusted gross income must be used to determine poverty level.

	Federal Adjusted Gross Income	Hawaii Adjusted Gross Income
COLA	Not included	Included
Contribution to State Employees' Retirement System	Not included	Included
Out-of-state Bonds	Not included	Included
Employers-funded Pensions	Included	Not included
Social Security Benefits	Included	Not included
First \$5,881 of Military Reserve or Hawaii National Guard Duty Pay	Included	Not included
Payments to An Individual Housing Account	Included	Not included

The number of people in a household is determined by the number of exemptions reported in the tax return (self, spouse, children and dependent, but excludes an additional exemption due to age sixty five and over).

To estimate the potential revenue loss of eliminating individual income tax for those with income below poverty level, the ordinary income tax rate is set at zero percent if both the FAGI

and HAGI is less than the 2012 poverty guidelines as established by the U.S. Department of Health and Human Services.

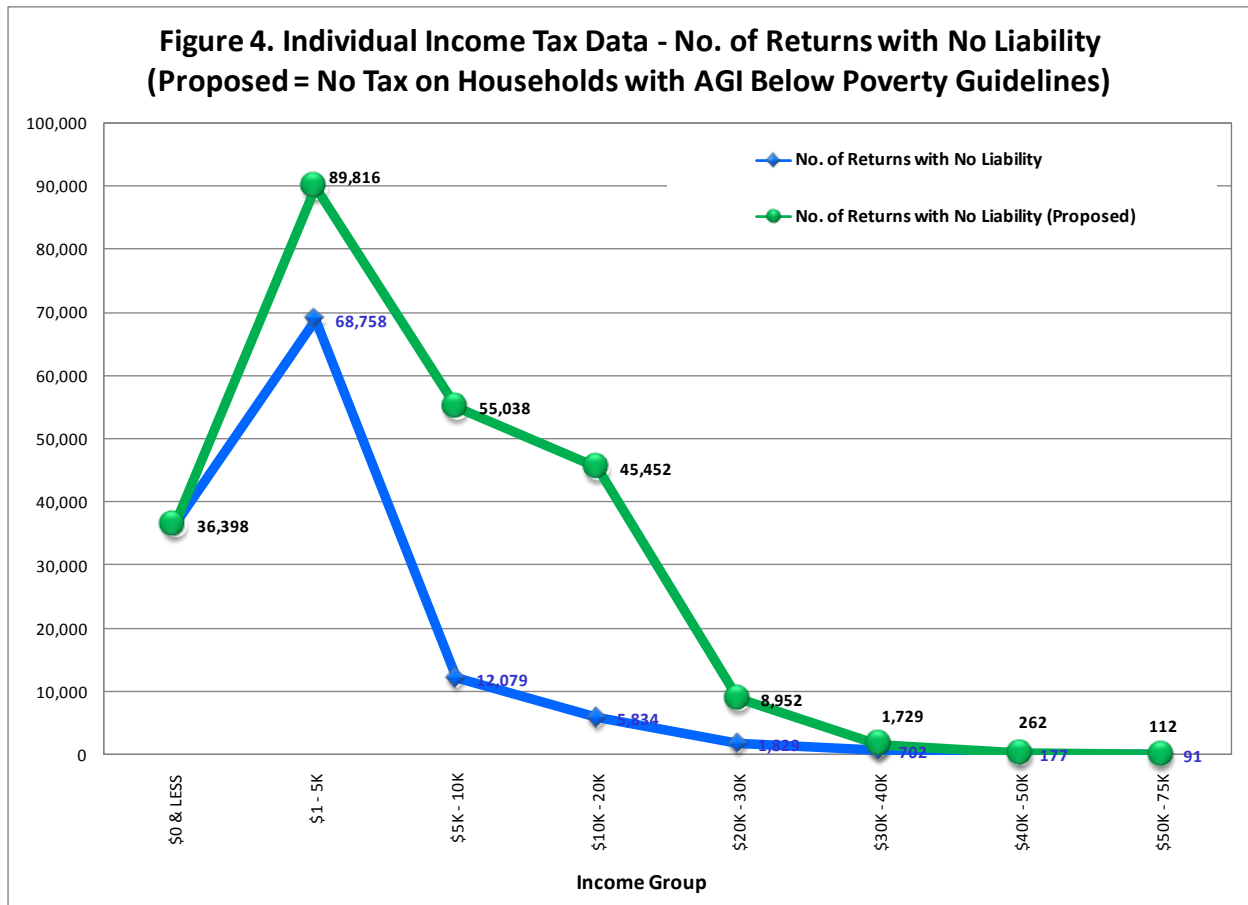
Formula:

IF HAGI < (\$8,310 + (\$4,550 * Regular Exemption)) AND

FAGI < (\$8,310 + (\$4,550 * Regular Exemption)) THEN Ordinary Liability = 0

Results

It is estimated that if those with FAGI and HAGI below poverty guidelines were exempted from individual income tax, the number of returns with no tax liability will increase by 111,900 returns (an 89% increase), representing almost 18% of total tax returns (see Figure 4).



The reported liability would decrease by \$17.7 million. Using the U.S. Department of Labor, Bureau of Labor inflation calculator, the estimated reduction in reported liability in 2012 would be \$21.5 million⁶. However, the revenue loss is likely higher. It could be several times higher than the estimated reduction in reported liability. The Department of Taxation’s records

⁶ U.S. Department of Labor, Bureau of Labor Statistics at <http://data.bls.gov/cgi-bin/cpicalc.pl>

showed a 12-years average difference between reported liability and tax collection of \$143 million (or about 14% of individual income tax collected). A possible explanation for the difference is that taxpayers who falls below the filing requirement or owes little to no tax that have withholding by their employers, did not file their tax returns⁷. Therefore, the revenue impact of exempting from individual income tax those is poverty is likely much greater than the \$21.5 million estimated reduction in reported liability.

IV. Discussion

Defining “income” to determine poverty level is not an easy task. The issue with using adjusted gross income is that it includes business loss, capital loss, depreciation, etc. Taxpayers with low adjusted gross income may not necessarily be poor. It could be that those taxpayers have a big capital loss for the year, for example.

Income tax reliefs, such as the food/excise tax credit and low income household renters’ credit are available to lower income households. Alternative options to provide tax reliefs to lower income households are increasing the food/excise tax credit amounts, increasing the credit amount for the low income household renters, indexing/increasing standard deduction, and indexing/increasing personal exemptions. The indexing/increasing standard deduction and personal exemptions are not as targeted to the lower income households as the food/excise tax credit and the renters’ credit.

⁷ Reported tax liability data are from tax returns, whereby tax collection data include withholding of income tax by employers. If taxpayers below poverty level are exempted from individual income tax, the employers will no longer have to withheld taxes for those with income below poverty level; hence, tax collection will decrease.