APPENDIX D:

REPORT OF MS. TITIN L. SAKATA AND MR. DONGLIANG WU –

“Effects of Eliminating the Hawaii Individual Income Tax for Taxpayers with Income Below Poverty Level”

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

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December 1, 2017

I. Introduction

The 2015-2017 Tax Review Commission requested an updated 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 ways 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, tax credits, or noncash benefits such as housing subsidies, Medicaid, and food stamps. The poverty thresholds as defined by the Census Bureau do not vary by geographical area[1]. Table 1 shows poverty thresholds for 2016.

Table 1. Poverty Thresholds for 2016 by Size of Family and Number of Related Children Under 18 Years

Size of family unit	Weighted Average Thresholds*	Related children under 18 years								
		0	1	2	3	4	5	6	7	8 or more
One person (unrelated individual):	$12,234									
Under age 65	12,486	12,486								
Aged 65 and older	11,511	11,511								
Two people:	$15,585									
Under age 65	16,153	16,072	16,543							
Aged 65 and older	14,523	14,507	16,480							
Three people	$19,109	18,774	19,318	19,337						
Four people	24,563	24,755	25,160	24,339	24,424					
Five people	29,104	29,854	30,288	29,360	28,643	28,205				
Six people	32,953	34,337	34,473	33,763	33,082	32,070	31,470			
Seven people	37,465	39,509	39,756	38,905	38,313	37,208	35,920	34,507		
Eight people	41,547	44,188	44,578	43,776	43,072	42,075	40,809	39,491	39,156	
Nine people or more		53,155	53,413	52,702	52,106	51,127	49,779	48,561	48,259	46,400

Source: U.S. Census Bureau.
Note: *Preliminary figures

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 2017[2]:

[1] Source: U.S. Census Bureau, http://www.census.gov/hhes/www/poverty/about/overview/measure.html
[2] Source: U.S. Department of Health and Human Services, http://aspe.hhs.gov

Table 2. Poverty Guidelines for 2017			
Persons in Family/Household	48 Contiguous States and the D.C.	Hawaii	Alaska
1	$12,060	$13,860	$15,060
2	$16,240	$18,670	$20,290
3	$20,420	$23,480	$25,520
4	$24,600	$28,290	$30,750
5	$28,780	$33,100	$35,980
6	$32,960	$37,910	$42,210
7	$37,140	$42,720	$46,440
8	$41,320	$47,530	$51,670
For families with more than 8 persons, add:	$4,180/additional person.	$4,810/additional person.	$5,230/additional person

III. Who Pays Hawaii Individual Income Tax?

Every individual doing business in Hawaii and every individual receiving gross income subject to Hawaii income tax law must file Hawaii income tax return. The filing thresholds for individuals receiving gross income subject to Hawaii income tax law, calculated by adding the standard deduction and personal exemption, as follows[3]:

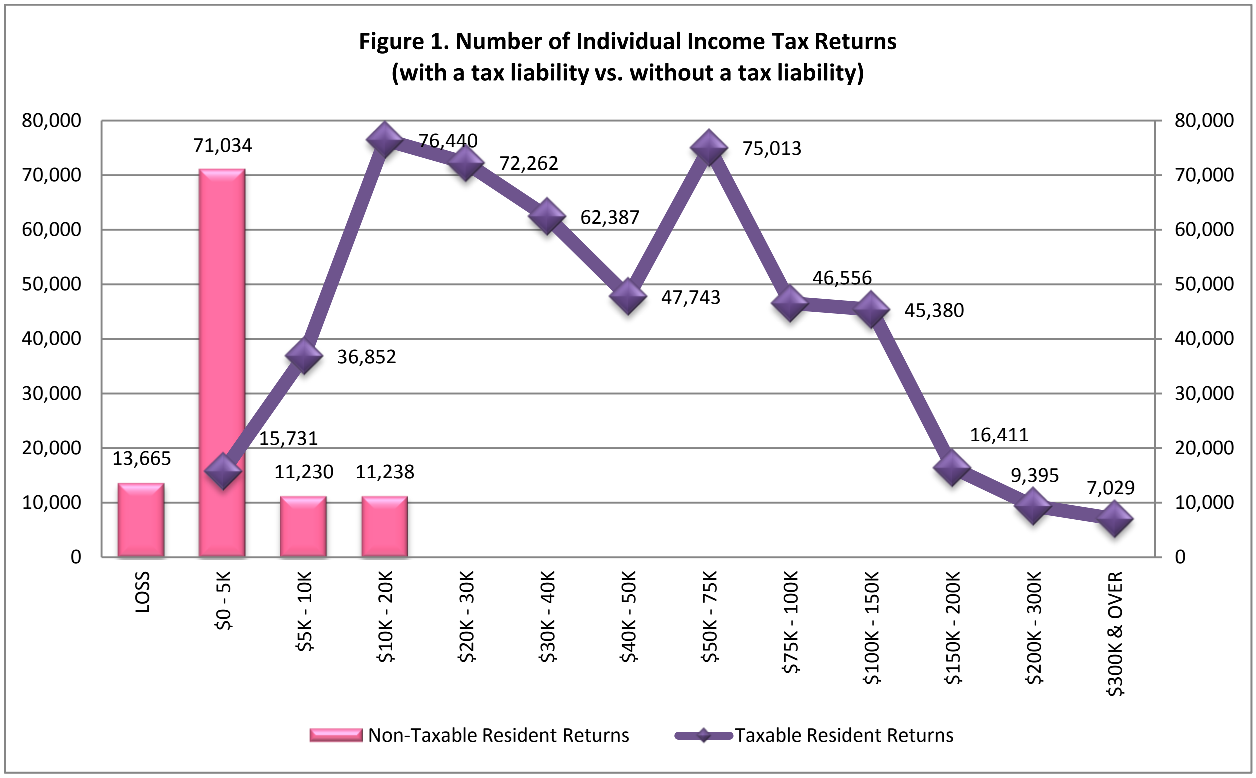
Filing Status	Standard Deduction	Personal Exemption	Total
Single; Married filing separately	$2,200	$1,144	$3,344
Head of household	$3,212	$1,144	$4,356
Married filing jointly	$4,400	$2,288	$6,688
Married filing jointly with 2 children	$4,400	$4,576	$8,976

Hawaii filing thresholds are relatively low compared to the federal thresholds. As a the comparison, the 2017 Federal filing thresholds (calculated by adding the standard deduction and personal exemption) are included in the table below.

Filing Status	Standard Deduction	Personal Exemption	Total
Single; Married filing separately	$6,350	$4,050	$10,400
Head of household	$9,350	$4,050	$13,400
Married filing jointly	$12,700	$8,100	$20,800
Married filing jointly with 2 children	$12,700	$16,200	$28,900

[3] Individuals age 65 and over are entitled to additional exemption of $1,144 per qualified person.

A total of 618,366 individual income tax returns were filed by Hawaii residents for tax year 2014. Of the total resident returns, 83% (511,199) reported a tax liability, and 17% (107,167) reported no tax liability (before applying any tax credits) (see Figure 1). Non-residents filed a total of 85,182 returns.



The total liability for tax year 2014 was $1.79 billion. Although resident taxpayers with Hawaii adjusted gross income ("HAGI") of under $50,000 represents a majority (61%) of the returns with a tax liability, the amount of their total tax liability only accounts for 16% or $0.29 billion of the total individual income tax. The majority of the individual income tax, 84% ($1.50 billion), was paid by resident taxpayers with HAGI over $50,000.

Taxpayers with HAGI of $100,000 or more represent 15% of returns with a tax liability, but accounts for 60% or $1.07 billion of the total individual income tax. Taxpayers with HAGI of $300,000 or more represent 1.4% of returns with a tax liability, but accounts for 26% or $0.46 billion of total individual income tax (see Figure 2).

The average tax liability within the various income groups range from $17 (for those with HAGI of $0 to $5,000) to $64,835 (for those with HAGI of $300,000 or more). The effective tax rates range from 1.5% to 8.7% (see Figure 3).

Figure 2. Individual Income Tax: Tax Liability by Income Group

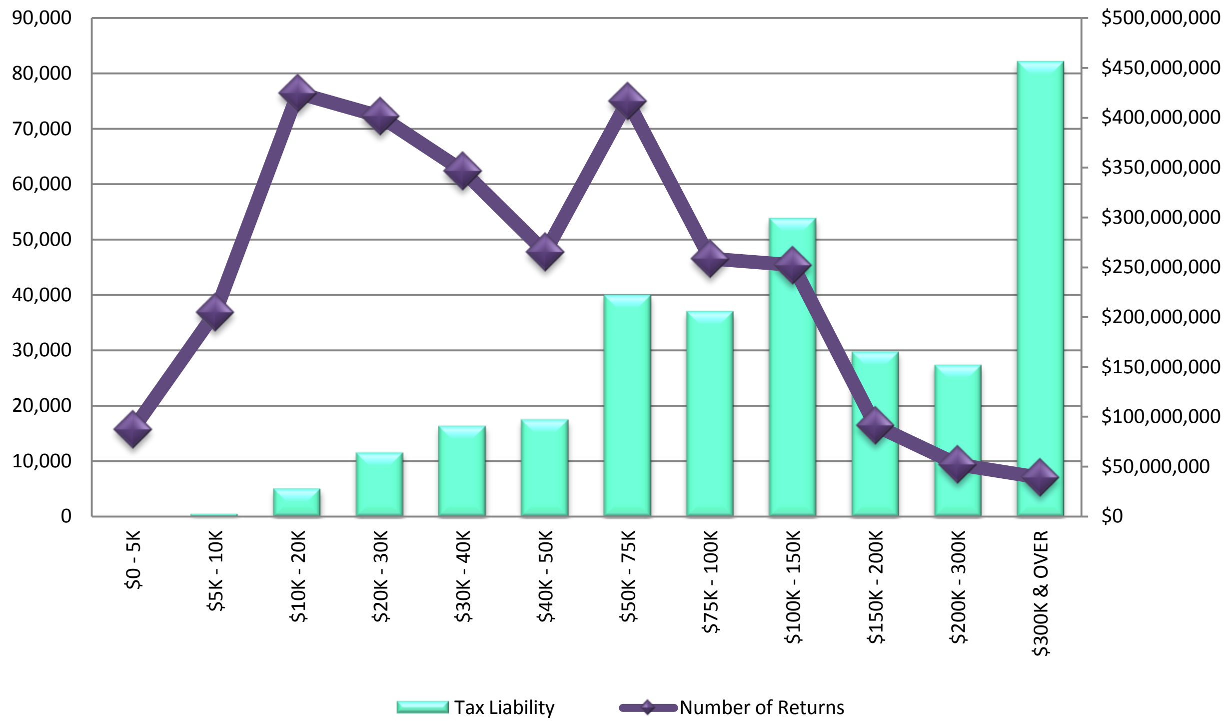
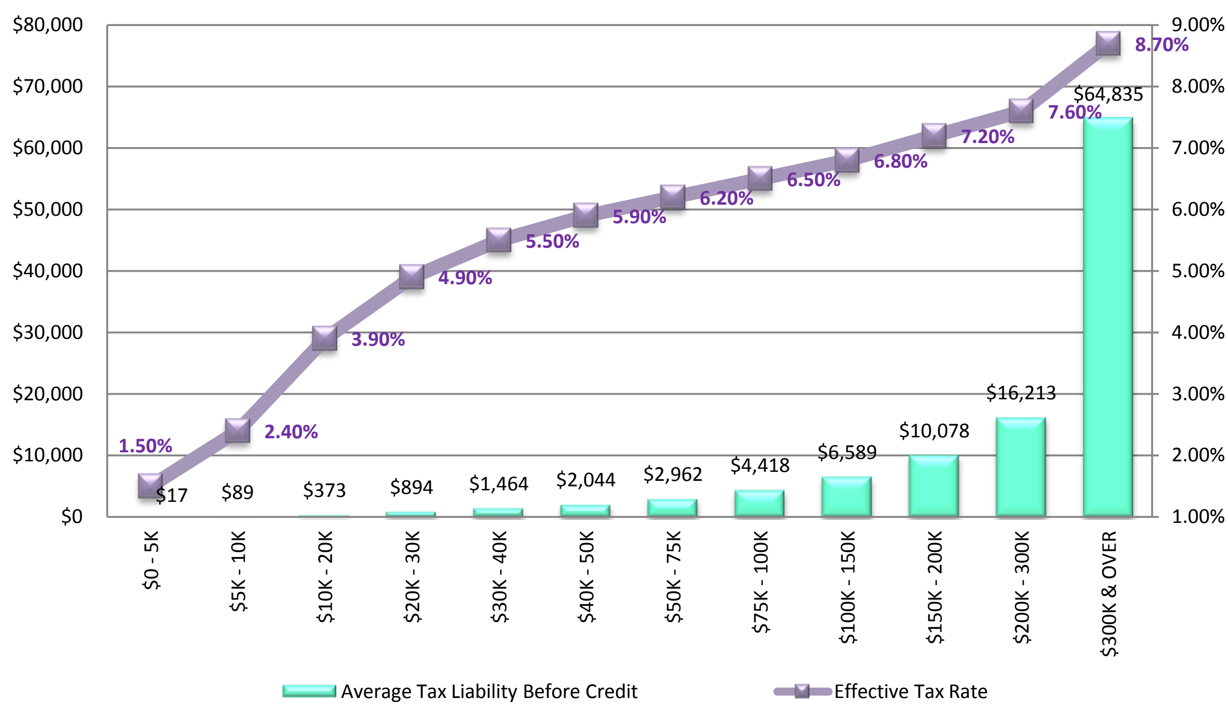


Figure 3. Individual Income Tax: Average Tax Liability (Before Credits)



IV. Tax Credits to Promote Social Welfare

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 credit and the income tax credit for low-income household renters.

Food/Excise Tax Credit

The food/excise tax credit[4] (food credit) is a graduated amount based on income level, which is determined by the FAGI, and the number of qualified exemptions (see Table 3). There is no limit to the number of qualified exemptions that the taxpayers may claim. The food credit is determined by multiplying an allowable tax credit amount by the number of qualified exemptions. For tax year 2014, claims for the food credit totaled $27.7 million on 325,713 individual income tax returns (46% of the returns filed for tax year 2014).

The food 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 credit of $550. If this family of five does not have any income tax liability, they will receive a refund of $550.

Table 3. Food/Excise Tax Credit

Federal AGI	Single Filer	All Other Filers				
	Tax Credit Amount	Tax Credit Amount for Households of:				
		1	2	3	4	5
Under $5,000	$110	$110	$220	$330	$440	$550
$5,000 - $10,000	$100	$100	$200	$300	$400	$500
$10,000 - $15,000	$85	$85	$170	$255	$340	$425
$15,000 - $20,000	$70	$70	$140	$210	$280	$350
$20,000 - $30,000	$55	$55	$110	$165	$220	$275
$30,000 - $40,000	$0	$45	$90	$135	$180	$225
$40,000 - $50,000	$0	$35	$70	$105	$140	$175
$50,000 and over	$0	$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

[4] 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. Act 223, SLH 2015, temporary modifies the food/excise tax credit and increases the amount of the credit for tax years 2016 and 2017. Act 107, SLH 2017 made Act 223, SLH 2015, changes permanent.

(see Table 4). The renter's credit is limited to taxpayer with HAGI of under $30,000[5]. The renter's credit has not been adjusted for twenty two years. For tax year 2014, claims for the renter's credit totaled $3.6 million on 35,030 individual income tax returns.

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	6
Under $30,000	$50	$100	$150	$200	$250	$500

Earned Income Tax Credit

Hawaii earned income tax credit (EITC) is 20% of the federal EITC for the tax year. However, unlike federal EITC, it is non-refundable, meaning if the EITC exceeds taxpayer's tax liability, only the amount up to the tax liability can be claimed. It is applicable for tax years 2018 to 2022.

The Department of Taxation estimated that the EITC will result in savings of $16.7 million in tax year 2019 for those that qualified for the credit[6].

Tax Liability After Tax Credits

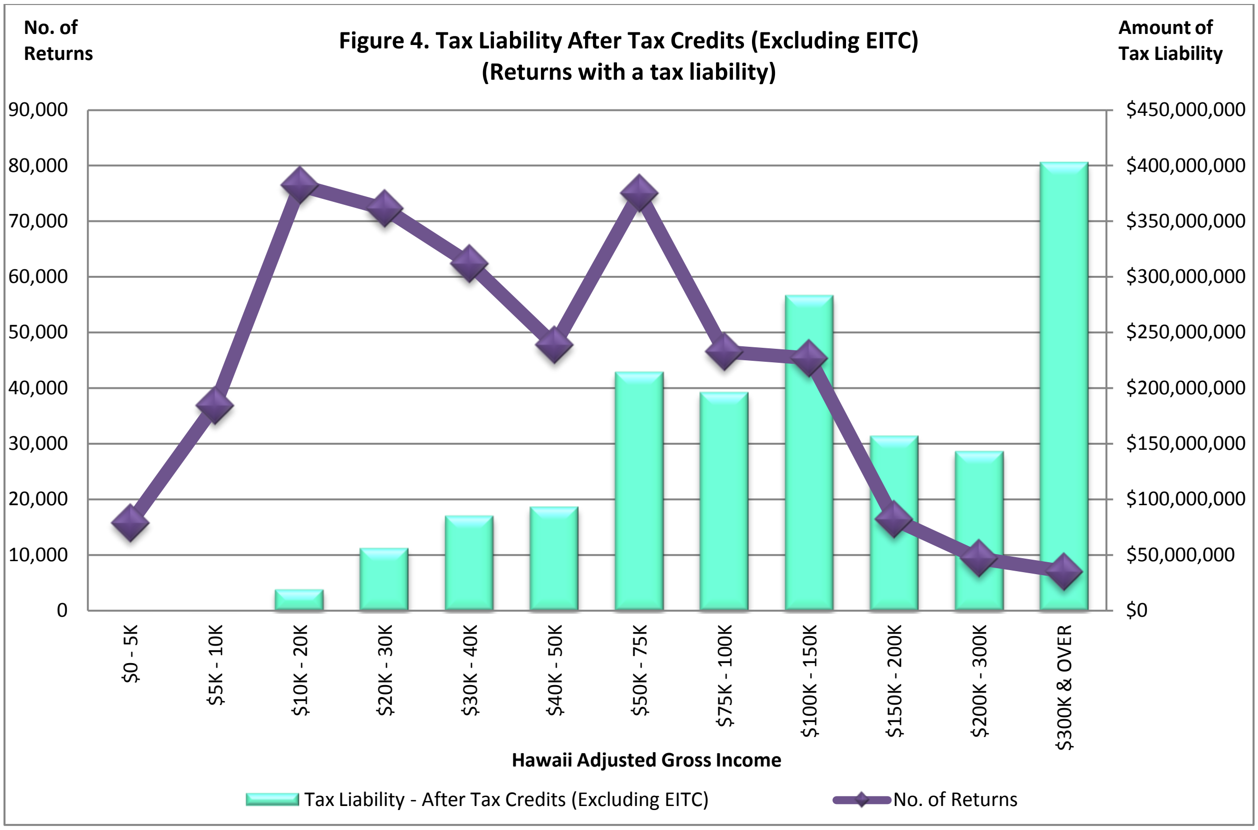
For tax year 2014, taxpayers with HAGI of under $50,000 paid 15% ($254.1 million), and the rest of the taxpayers paid 85% ($1.35 billion) of the total individual income tax after tax credits. Taxpayers with HAGI of $100,000 paid 60% ($984.7 million) of the total individual income tax after tax credits. Taxpayers with HAGI of $300,000 paid 24% ($402.1 million) of total individual income tax after tax credits (see Figure 4).

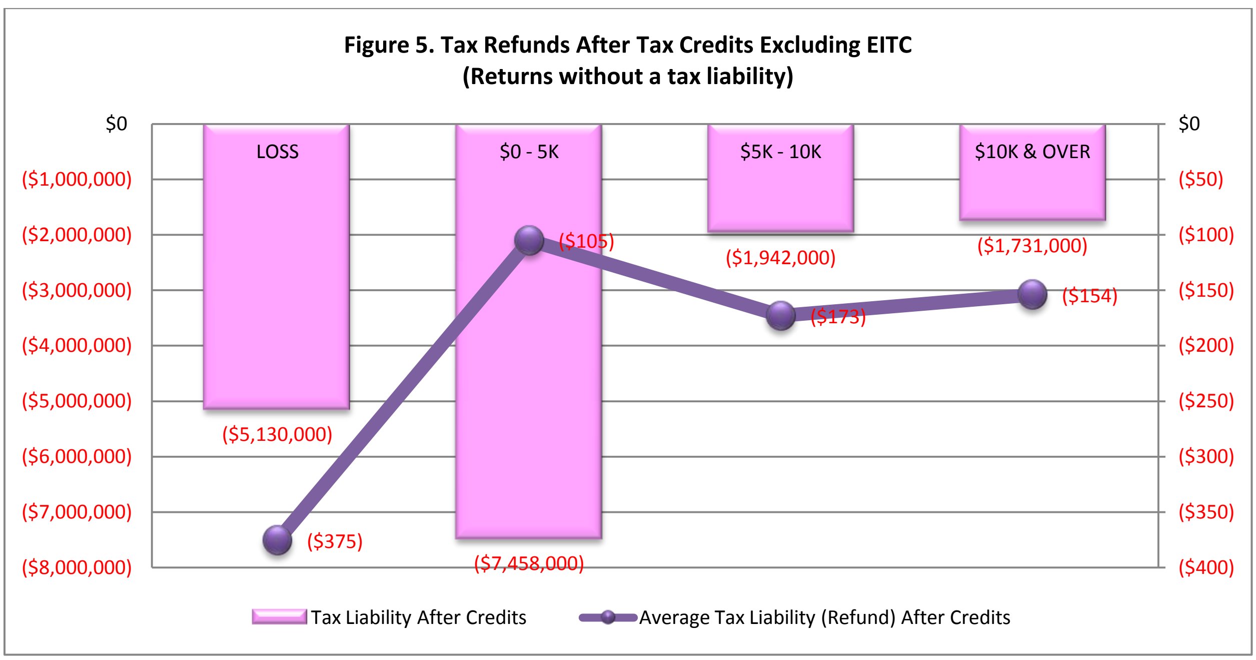
Generally, the targeted tax credits resulted in refunds for non-taxable individual income tax returns. Tax credits claimed in the 107,167 *non-taxable returns* for tax year 2014 totaled $16.3 million. The average refund is $375 for returns with losses, $105 for returns with $0 to

[5] 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. 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).

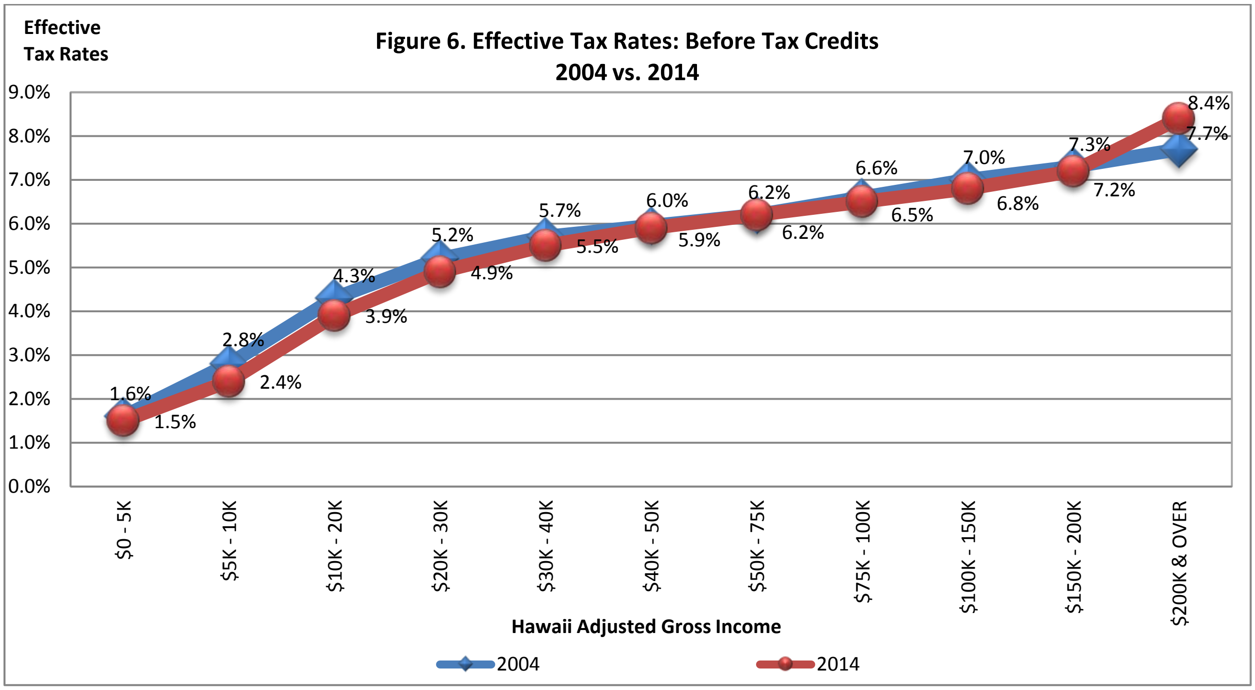
[6] Standing Committee Report No. 1338 re: H.B. 209, H.D. 1, S.D. 1, Regular Session of 2017.

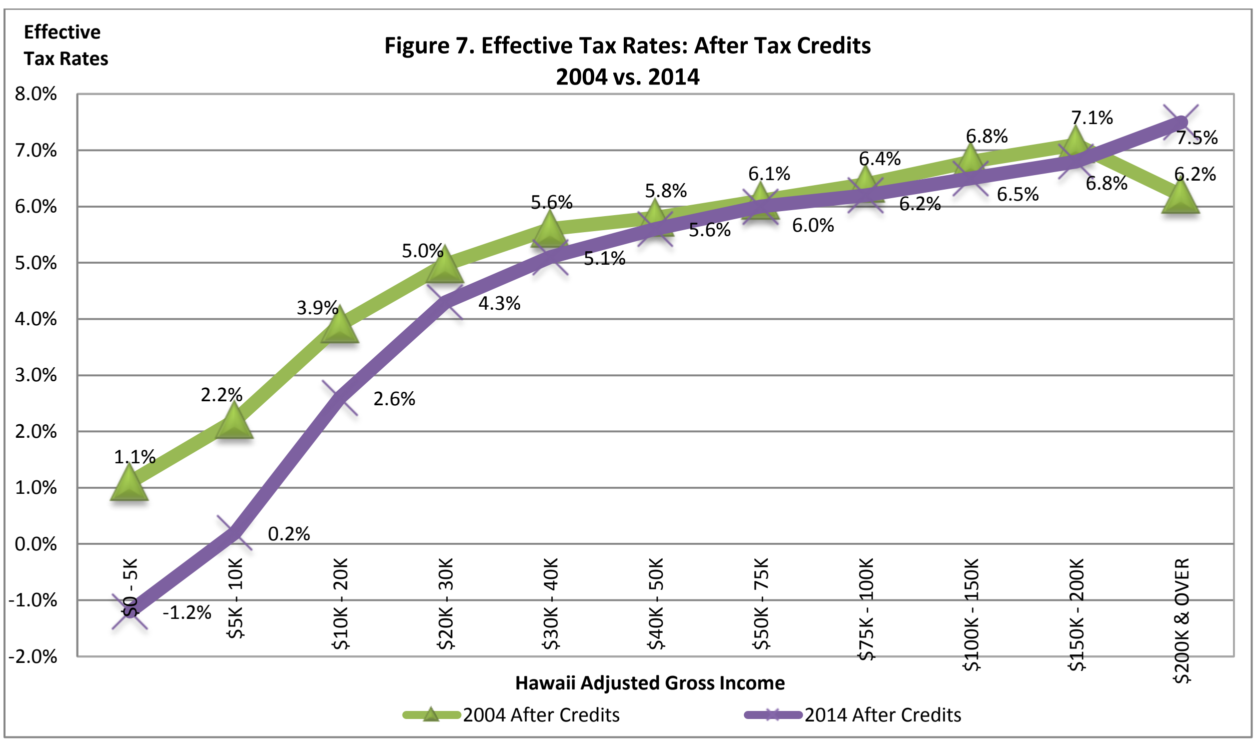
$5,000 HAGI, $173 for $5,000 to $10,000 HAGI and $154 for $10,000 and over HAGI (see Figure 5).



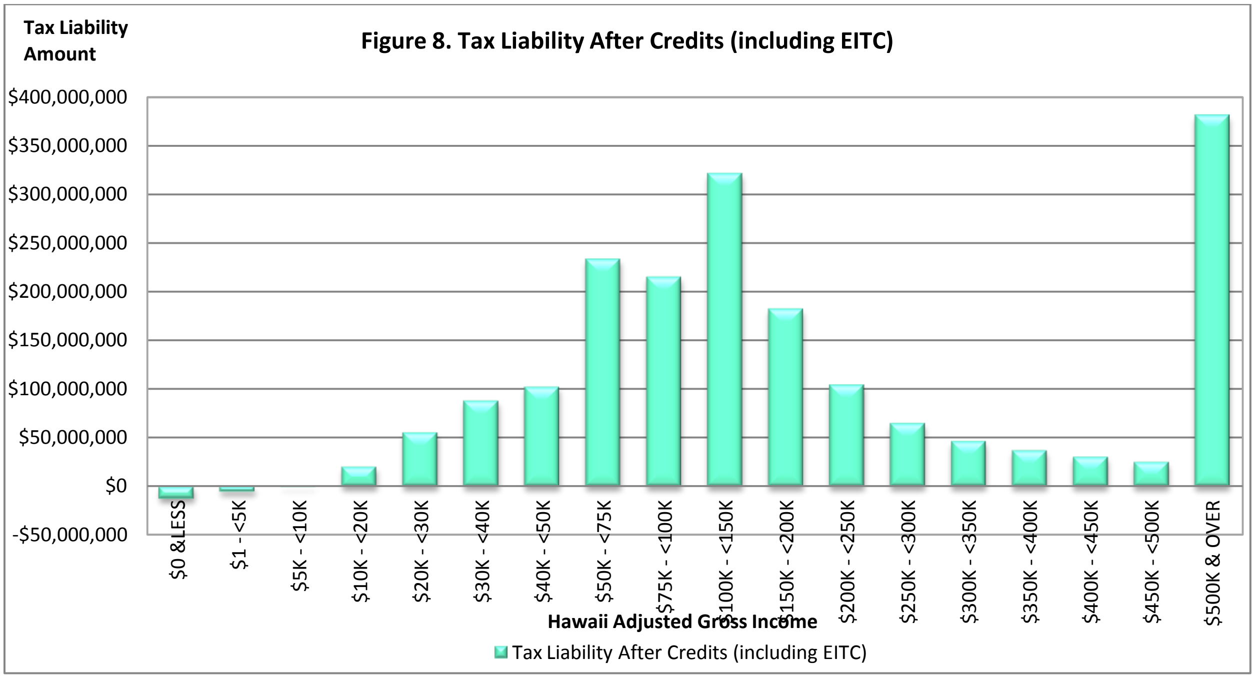


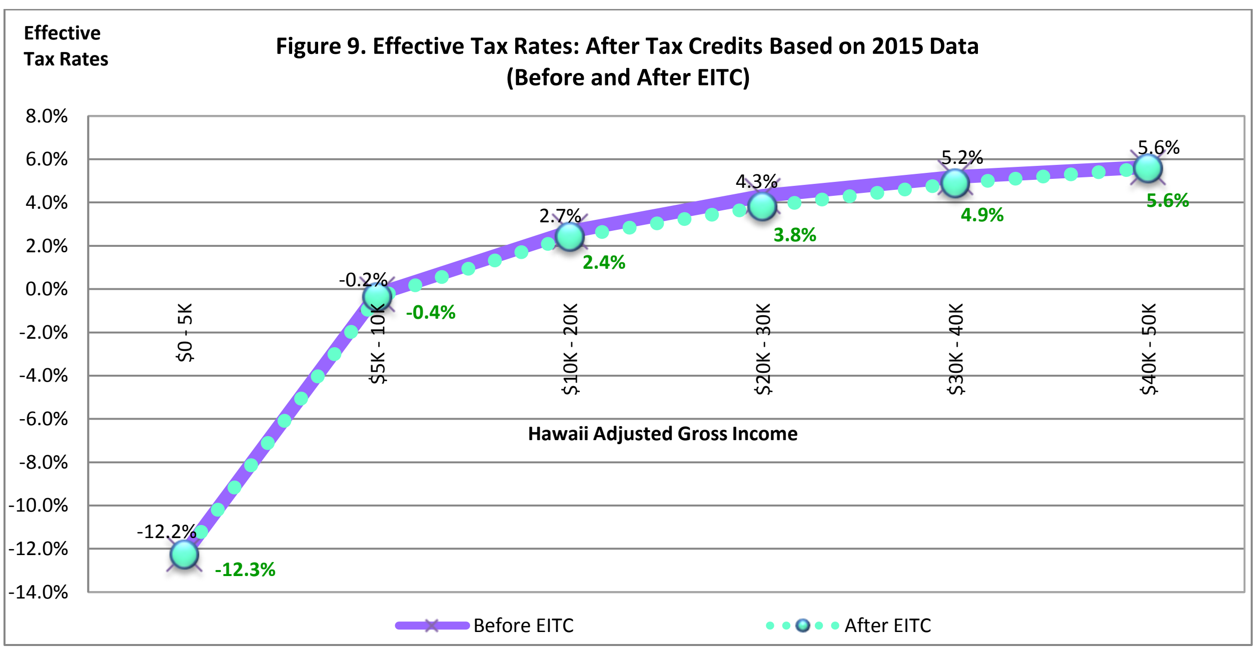
Over the years, the Legislature has passed legislations to promote social welfare. Comparing the effective tax rates for tax year 2004 to tax year 2014, generally, there is an overall decrease in the effective tax rates for all income group, particularly, for taxpayers with HAGI under $50,000 after tax credits (see Figures 6 and 7).





The State non-refundable EITC as it becomes effective beginning with tax year 2018 will further reduce the income tax liability for family in needs. A statistical simulation using tax year 2015 data shows the EITC reducing the tax liabilities and the effective tax rates for taxpayers with HAGI under $50,000 (see Figures 8 and 9). A negative effective tax rates mean taxpayers have no tax liability and are getting refunds, mainly due to tax credits to promote social welfare.





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 $6,279 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.

Table 5. Examples of Differences between FAGI and HAGI

	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 $6,279 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 2017 poverty guidelines as established by the U.S. Department of Health and Human Services.

Formula:

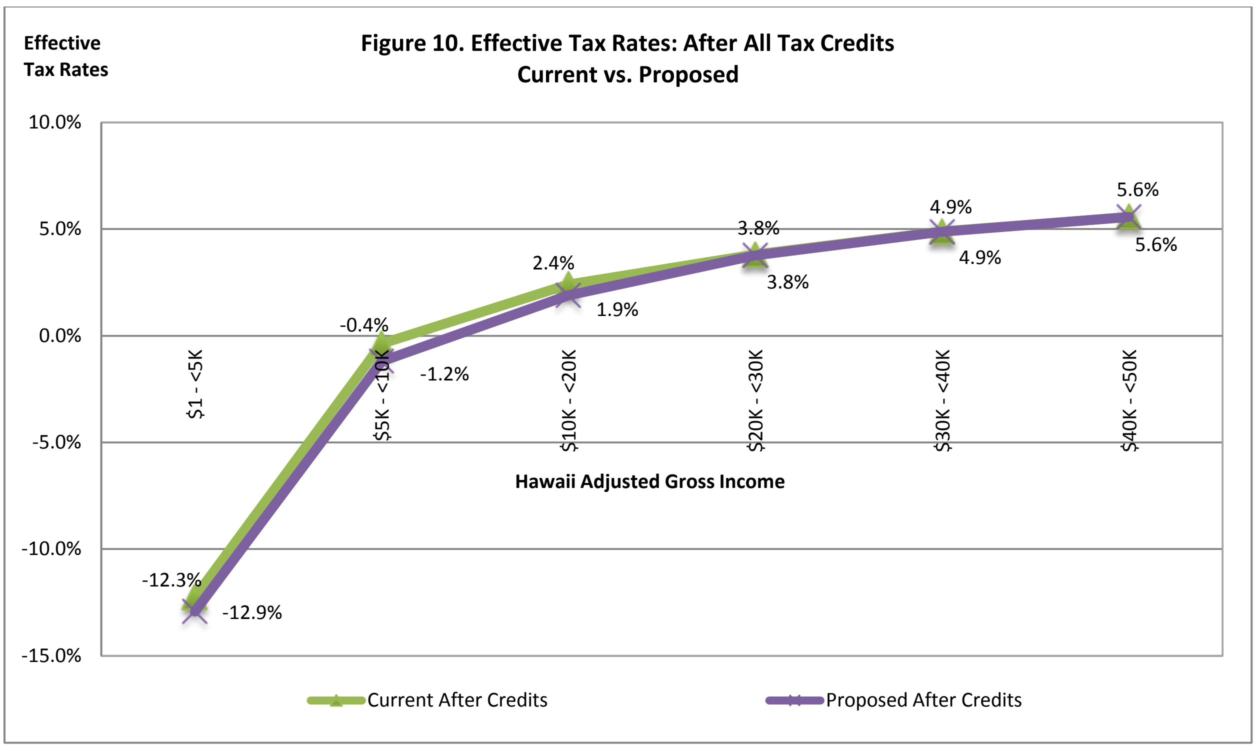
<u>IF</u> HAGI < ($9,050 + ($4,810 * Regular Exemption)) <u>AND</u>

FAGI < ($9,050 + ($4,810 * Regular Exemption)) <u>THEN</u> Ordinary Liability = 0

<u>Results</u>

Using the latest available data, tax year 2015 data, it is estimated that if those with FAGI and HAGI below poverty guidelines were exempted from individual income tax, only the effective tax rates for those with income below $30,000 will decrease further after tax credits (see Figure 10).

This exercise shows no impact to taxpayers with income of $30,000 and above. One conclusion is that the newly enacted EITC eliminates tax liability for most taxpayers with income below poverty guidelines; thus, this exercise has minimal impact to those taxpayers.



The reported liability would decrease by $19.6 million. Using the U.S. Department of Labor, Bureau of Labor inflation calculator, the estimated reduction in reported liability in 2017 would be $20.4 million[7]. 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

[7] U.S. Department of Labor, Bureau of Labor Statistics at http://data.bls.gov/cgi-bin/cpicalc.pl

showed a 20-years average difference between reported liability and tax collection of over $100 million (or average of over 10% 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 returns[8]. Therefore, the revenue impact of exempting from individual income tax those in poverty is likely much greater than the $20.4 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 credit and renter's credit are available to lower income households. Alternative options to provide tax reliefs to lower income households are increasing the amount of the food credit and renter's credit, indexing/increasing standard deduction, and indexing/increasing personal exemptions. 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.

[8] 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, individual income tax collection will likely decrease accordingly.