MEMORANDUM

Date: July 27, 2021

To: Tax Review Commissioners

From: Commissioner Kate Lloyd

RE: Proposed 2022 Tax Review Commission Recommendations

Proposed 2020 Tax Review Commission Recommendations

Modernize Hawaii's individual income tax by increasing the personal exemption and standard deduction, with the amount of the recommended increase based on projections provided by the consultant and/or Department of Taxation's Office of Tax Research and Planning. Provide for an automatic index for inflation thereafter, for both the personal exemption, and standard deduction. Secondarily, consider adjusting the tax brackets and tax rates to simplify the structure, and provide better tax revenue neutrality if necessary, also with an index for inflation.

Discussion

The standard deduction and personal exemption in Hawaii's individual income tax system have been eroded over time by inflation and are now outdated and provide little relief to low wage earners and other filers. Hawaii's personal exemption amount is $1144 per exemption and appears not to have been updated, or to have been updated only slightly since 2009. The standard deduction amounts are currently as follows: single or married filing jointly $2200; married filing jointly or qualifying widower $4400; head of household $3212. I was unable to determine the last time the standard deduction was adjusted but these are the same amounts reflected in the 2017 Tax Review Commission (TRC) report.

The same or similar recommendations have been made by both the 2017 and 2012 TRC as a way to eliminate the income tax for those below the poverty level and increase progressivity of the overall tax system. One of the primary issues of the 2015 – 2017 TRC was to lessen the burden on those who can least afford to pay. The 2017 PFM study identified increasing the standard deduction as one of the optimal alternatives for reducing regressivity in Hawaii's tax system. The PFM study estimated the revenue loss for an increase in the Standard Deduction to $7,500 for single filers, $15,000 for married and $10,950 for head of household at $61 Million. One of the primary findings from the 2017 study was that “although tax credits eliminate the latent tax liability for most households with income below the poverty threshold, there are still instances where they are required to pay the state income tax”.

Likewise, one of the recommendations of the 2015 – 2017 TRC was to increase the personal exemption and standard deduction to the levels in the federal income tax as of tax year 2017 and index for inflation thereafter. Note that the significant increase in the federal standard deduction in 2018 made the disparity between state and federal standard deduction even more significant than that raised by prior commissions. The revenue loss inherent in matching the new federal standard deduction may be much more significant than the $61 million estimated in 2017. The 2017 report identified that the first step in making the adjustment would be for the Department of Taxation’s Office of Tax Research and Planning to provide various options from which the Legislature may choose. I do not know if these scenarios were ever calculated or not, but it would be useful to have several specific options, together with revenue impact and numbers of anticipated taxpayers affected from which the legislature could choose if they decide to modernize Hawaii’s tax system.

<u>Questions to be addressed by DOTAX or the Consultant</u>:

- Estimate the revenue loss for increasing the standard deduction and personal exemption under two or three different scenarios: For Example, the amounts proposed in the 2017 TRC report, aligning the Hawaii standard deduction and personal exemption with the new federal levels in a mid-range scenario between the two.

- Would increasing the standard deduction and/ or personal exemptions eliminate the need for many or most low-income taxpayers to file Hawaii state tax returns? The filing thresholds for individuals receiving gross income subject to Hawaii income tax law, is calculated by adding the standard deduction and personal exemption. Would withholding rates need to be adjusted accordingly so that a taxpayer that fell below the threshold need not file or would a low- income earner still need to file to get a refund for withholding?

- How many taxpayers would benefit from the increase? With the Earned Income Tax Credit, much of the liability for these taxpayers might be eliminated anyway, if so, an argument can be made that the changes are revenue neutral but at the same time would increase simplicity of the tax system if avoiding the need to file.

A secondary recommendation to explore would be whether Hawaii should simplify its rate structure by eliminating or combining some of the brackets and adjusting the rates. This might also be required if the increase in the standard deduction/personal exemption discussed above results in a bigger revenue loss that must be offset elsewhere.

There appears to have been significant changes to the tax brackets over the years. In 2009, the legislature added three income tax brackets on higher income earners. When enacted, Hawaii had the highest top individual income tax rate and the most brackets of any state. These changes sun setted on December 31, 2015. Although during the 2012 TRC, there was discussion about maintaining the rate structure, the top three rates sun setted in 2015. In 2017, the legislature enacted, and the governor approved, a return to the additional brackets. With the return of the three top marginal income tax brackets Hawaii again has 12 brackets, the largest number of any state with an individual income tax bracket. Hawaii's lower brackets are closely spaced, meaning average income earners move quickly to higher marginal tax rates than in most states.

<u>Questions to be addressed by DOTAX or the Consultant</u>:

- Depending on the projected revenue loss from this and other 2022 Tax Review Commission recommendations, should we explore whether a compression of the brackets is a viable possibility for making up some of the lost revenue? Would a compression of the brackets unfairly burden middle- and high-income earners in an already high tax jurisdiction?
- If a new rates structure is recommended, would it make sense to index for inflation going forward? Would indexing for inflation be administratively burdensome for DOTAX to keep the forms/tables current?

I look forward to our discussion on Wednesday.