MEMORANDUM

Date: October 12, 2021

To: Tax Review Commissioners

From: Commissioner Kate Lloyd

RE: Proposed 2022 Tax Review Commission Recommendations on Personal Exemption and Standard Deductions

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I am submitting the following proposed recommendation for the commission's discussion and decision-making at our meeting on October 13, 2021.

The Hawaii Tax Review Commission urges the legislature to modernize Hawaii's individual income tax by evaluating an increase in 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 and provide for an automatic index for inflation thereafter for both the personal exemption and standard deduction.

The standard deduction and personal exemption in Hawaii's individual income tax system have been eroded over time by inflation and are now outdated. Recommendations to increase the standard deduction have been made by all past Tax Review Commissions and this has been identified as a way to eliminate the income tax for those below the poverty level and increase progressivity of the overall tax system. The 2017 PFM study identified increasing the standard deduction as one of the optimal alternatives for reducing regressivity in Hawaii's tax system.

<u>Questions to be addressed by DoTax or the Consultant and incorporated into the recommendation</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 and a mid-range scenario between the two.

- Determine whether 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.

- Address whether withholding rates would need to be adjusted accordingly so more taxpayers would not need to file the return to get a refund for withholding.

- Address how many taxpayers would benefit from the increase and what demographic would be most benefited. 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- while the earned income tax credit may reduce overall tax liability – the changes discussed above may be more beneficial to lower income earners who could anticipate a change in positive cash flow.