

## **TAX REVIEW COMMISSION**

MINUTES OF THE FIFTEENTH MEETING OF THE  
TAX REVIEW COMMISSION  
HELD AT 830 PUNCHBOWL STREET, ROOM 221  
IN THE CITY AND COUNTY OF HONOLULU  
STATE OF HAWAII, ON TUESDAY, JULY 25, 2006

The Commissioners of the Tax Review Commission met at the Department of Taxation, Director Conference Room, in the City and County of Honolulu, State of Hawaii, on Tuesday, July 25, 2006.

**Members Present:** Chairman Isaac Choy, Manoa Consulting Group, LLC CPA's  
Vice-Chairman Ronald Heller, Torkildson Katz Fonseca Moore &  
Hetherington, AAL, ALC  
Carolyn Ching, Carolyn L. Ching CPA  
Christopher Grandy, UH Manoa, Public Administration Program  
Lon Okada, Hawaiian Electric Industries, Inc.  
John Roberts, Niwao & Roberts, CPA's

**Members Absent:** Melanie King, Bank of Hawaii

**Staff:** Tu Duc Pham, Donald Rousslang, Cathleen Tokishi, Dana Remigio

**Other:** Diane Erickson, Dept. of Attorney General  
Peter Fritz, Chun Kerr Dodd Beaman & Wong  
Craig Hirai, Bowen Hunsaker Hirai  
Lowell Kalapa, Tax Foundation of Hawaii  
Marilyn Niwao, Niwao & Roberts, CPAs  
Tom Smyth, DBEDT  
Nicki Thompson, Governor's Policy Office

### **CALL TO ORDER**

Chairman Isaac Choy called the meeting to order at 9:00 a.m. with a quorum present.

### **APPROVE MINUTES OF JUNE 27, 2006, MEETING**

The Chairman called for any corrections or additions to the minutes; there were none.

It was moved by Mr. Heller and seconded by Dr. Grandy to approve the minutes of June 27, 2006. The motion carried without opposition.

## ANNOUNCEMENTS

At its meeting in August, the TRC will consider whether Hawaii should adopt the Streamlined Sales and Use Tax Agreement. The Chairman stated that he didn't think it was that important that the Commission make a decision as to whether to recommend its adoption or not at that meeting. He noted that Dr. William Fox was to meet with the Commission on September 22, 2006, and that he was willing to entertain questions about the Streamlined Sales and Use Tax Agreement as he had only recently conducted the study on this matter for the Office of the Auditor. The other commission members were asked if they would consider deferring decision-making to some later date after hearing from everyone they should be hearing from, especially from Dr. Fox.

Ms. Ching agreed. Mr. Heller noted that the discussion would still take place, but that decision-making could be deferred. Mr. Smyth noted that a large number of people who may not attend the meeting with Dr. Fox are expected at the August meeting; they should be heard at that time, though decision-making can be deferred until after the meeting with Dr. Fox.

The Chairman noted that they are anticipating a large number of attendees, which is why the location of the August meeting has been changed to the Senate Ways and Means Committee Hearing Room at the Capitol.

Mr. Heller asked Mr. Hirai if there was anything new from the committee that is working on the Streamlined Sales and Use Tax. Mr. Hirai indicated that they haven't reconvened so there wasn't anything new.

The Chairman asked Ms. Remigio about plans for publicity; there are no special plans at this time, but the Chairman would like the Commission to ensure that the stakeholders are notified. He asked Mr. Hirai who he thought should be notified. Mr. Hirai mentioned the Carol Pregil of the Retail Merchants, a proponent; he is unsure of who the opponents are. Mr. Heller stated that something could be sent to the tax committees of the State Bar and Hawaii Society of CPAs.

Mr. Hirai stated that most of the opponents tended to be from the neighbor islands stemming from Director Kawafuchi's testimony about Big Island cookies and the like. Mr. Smyth concurred, and added certain populist groups and the right-wing, no-tax people. The Chairman noted that he is neither a proponent nor an opponent and would like to hear from the opponents as well. He will, however, leave it up to Ms. Remigio.

Mr. Heller asked about sending out a press release to Pacific Business News, Public Radio, and other such organizations. Ms. Tokishi will take care of drafting the news release and getting it to the media and to other organizations; it should go out as soon as possible.

Ms. Ching asked how the work of the Streamlined Sales and Use Tax Committee that Mr. Hirai is serving on is related to the Tax Review Commission and what it is doing. Mr. Hirai stated that his committee is technically a committee of the State Legislature and is composed principally of proponents of the Streamlined Sales and Use Tax, which is how the Legislature chose them. The committee is currently on hiatus because of sourcing issues that are holding up the Streamlined Sales Tax Project. Until now, the Streamlined Sales and Use Tax Agreement has used destination-based sourcing. However, some counties in some states are apparently unwilling to give up origin-based sourcing, and that is creating some turmoil. The committee is waiting to see how that is resolved.

Ms. Ching summarized that Mr. Hirai's committee is a legislative committee that will report to the Legislature and that the Tax Review Commission is independent of Mr. Hirai's committee. That was confirmed, and the Chairman noted that it was that committee that commissioned the study by Dr. Fox on the Streamlined Sales and Use Tax.

At its meeting in September, the TRC will provide the results of its work on the internal study on recommendations made by past Commissions. The Chairman asked if the memorandum prepared by Ms. Tokishi and provided the previous day to the Commission members was part of the internal studies. Ms. Tokishi explained that it was, but since the topics dealt with the recommendations of past Tax Review Commissions, it is being provided in preliminary form for their use in discussing agenda item 5, "Review of Past TRC Recommendations."

The Chairman asked if all the internal studies would be completed by September. Dr. Rousslang anticipates that they will.

Dr. Pham stated that two studies are being requested of other Departments. A budget stabilization study is being requested of the Department of Budget and Finance and an unemployment insurance study is being requested of the Department of Labor and Industrial Relations. Letters to these Departments have been drafted for the Chairman's signature. The deadline for these reports is October 1, 2006.

Dr. William Fox will present the findings from external studies 1 and 3 ("Economic, Revenue and Distributional Impacts of the General Excise and Use Taxes," and "Economic Effects of Certain Possible Changes in Exemptions from the General Excise Tax") on Friday, September 22 at 1:30 P.M., in the Director's Conference Room. The Chairman reminded everyone of the special meeting at which Dr. Fox will answer questions about his draft reports, which are due sometime in August. Dr. Grandy noted that the date was scheduled with the understanding that the drafts would have been submitted in August such that the Committee members would have sufficient time to review the drafts before meeting with Dr. Fox.

Dr. Pham suggested that a special meeting also be scheduled for Dr. Marcia Sakai to discuss her draft report. Her preliminary report will be done by the August deadline, but she has requested a short extension of 10 to 15 days until October 15, 2006. Ms. Ching said that she'd need to look at a calendar to make sure they had enough time to review it. Mr. Heller noted that the October 15<sup>th</sup>

date occurs before the October meeting, so they should have enough time. Ms. Tokishi noted that October 15, 2006, is a Sunday so it would be due on October 16, 2006.

Dr. Pham stated that she could come for either the September or the October meeting. However, the Chairman stated that, since she's coming from the Big Island, a special meeting should be scheduled as was done for Dr. Fox. Dr. Pham and Dr. Rousslang will work out the dates.

The Chairman noted that the extension of the due date for the final report is a modification to the contract, so a vote should be taken for the record.

It was moved by Dr. Grandy and seconded by Mr. Roberts to grant an extension of the due date to October 16, 2006, for Dr. Sakai's final report. The motion was passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Melanie King	Absent
Lon Okada	Yes
John Roberts	Yes

The Chairman asked when the preliminary Commission Report was due. Dr. Rousslang stated that it originally was August but was changed to September.

The TRC will evaluate the results from its external studies at the meetings to be held in September (after the preliminary reports are due) and October (after the final reports are due). This was discussed earlier. No further discussion was held.

A preliminary draft of the TRC's report will be presented at the TRC meeting scheduled for September 26. This also was discussed earlier. No further discussion was held.

## **TAX ADEQUACY**

The Chairman noted that everyone should have had time to review the interim tax adequacy study done by Dr. Rousslang and called for a motion to accept that study.

Mr. Heller noted that several changes were suggested at the last meeting, and asked if there was a new version. Dr. Rousslang stated that the changes had not yet been done. The Chairman mentioned that the addition of the assumptions upon which the determination of tax adequacy was made, to which Mr. Heller added his suggestion to include an executive summary.

The Chairman agreed and asked if there were any other matters to discuss regarding the study other than those two items.

Dr. Grandy asked everyone thought that this report was useful enough to be continued, and if not, might they want to suggest that future commissions not do a tax adequacy study as this may not be as meaningful as people may have hoped.

Mr. Roberts stated that it is not worth the effort, in his view. There are so many assumptions behind the determination that, regardless of how hard they try, they will miss the mark as to future projections. Unless there is a concern that there is a systemic breakdown of the tax system, it should not be mandatory. They should defer to each commission.

Dr. Grandy asked if Mr. Roberts thought that one purpose of this study is to forecast revenues.

Mr. Roberts felt that forecasting was inherent in doing a tax adequacy study although that is not the purpose of the Commission. Since they have no control over expenditures either, the Commission is attempting to say that the tax system is adequate to meet the requirements of two elements over which they have no control. This is one of the tests for a sound tax system, but it may not be worth it given the effort involved.

Mr. Heller agreed that the Commission shouldn't tell future commissions how to do their job. He does, however, think that the study was worth doing and did have some interesting data. His only objection is to telling future commissions what to do.

Mr. Hirai's recollection is that there was something in either the Constitution or the statute that referenced adequacy. If they are not going to do this study, then they should double-check those references.

Mr. Kalapa noted that if this study is not done, then the Commission has no basis upon which to make its recommendations. Whatever the recommendation, if it is not proven that there are sufficient revenues to fund government, then the recommendation has no leg to stand on.

The Chairman stated that, early on, Dr. Pham and he discussed this issue. Upon reading the 1984 report, his opinion is that the requirement that the Commission opine on tax adequacy was quite clear. The 1984 statement was very simple; in the next five years, given the current tax structure, will there be enough money to fund the government at the current level of service. Since then, a number of economic factors have been added along with other economic impact stuff that complicated the matter. What he thinks this Commission will say is that taxes are adequate given certain assumptions."

Dr. Rousslang asked what they meant by "current level of services." The Chairman said he thought it was basically what they were getting. Mr. Heller asked if it was projected in a straight line according to population growth. Dr. Rousslang added another option, according to income growth. His study projected based on income growth, which is what the previous study being updated had done. Dr. Grandy added that they moved to that in 1989.

Mr. Kalapa stated that what the last two commissions missed is that, in light of the spending limits imposed by the 1978 constitutional amendments, the whole structure has shifted from the General Fund to a host of special funds. The Department of Commerce and Consumer Affairs, for example, went from being almost 100% funded by the General Fund in 1978 to being 100% funded by special funds in 2006.

The Chairman expressed concern that including that consideration would make the study overly complicated. Mr. Kalapa noted, however, that this issue needs to be considered because there actually may be too much taxes being collected as the system had been so restructured that the Legislature now hides revenues through the use of special funds, as was noted by the 1989 Commission.

Mr. Heller stated that he felt the Commission would address this issue when they discussed the transparency criteria of sound tax policy. At that point they talk about special funds versus general funds and whether the public is clear on what they are or are not getting for what they pay in taxes.

Dr. Grandy noted that this is the Tax Review Commission rather than the Public Financing Commission. However, the special fund phenomenon should be looked at and mentioned in the report, but noted that their mandate may be too narrow to really look at it such that some other group may need to look at it.

The Chairman asked if there were any other comments or suggestions regarding the tax adequacy report. There were none. They will review a revised draft at the October meeting.

## **REVIEW OF PAST TRC RECOMMENDATIONS**

The previously distributed list of past Tax Review Commission recommendations, supplemented by the additional information regarding the specific acts implementing the adopted recommendations, will be reviewed.

### **RECOMMENDATIONS OF THE 1984 TAX REVIEW COMMISSION**

These recommendations had been assigned to the Chairman, who led the discussion.

#### **Overall Tax Recommendations:**

##### **1. Maintain General Fund composite progressivity.**

This recommendation actually recommends the indexing of standard deductions, personal exemption, and tax rates with inflation.

Mr. Roberts was concerned about the practicality of the Department having to change the forms every year, but it is done for federal returns so it shouldn't be too difficult.

Mr. Smyth asked whether a local or mainland inflation index would be used. Mr. Kalapa stated that the Internal Revenue Service (IRS) uses the U.S. Consumer Price Index (CPI). Dr. Grandy felt that indexing to inflation was better than one-shot deals as was done in the 2006 legislation. Mr. Roberts was hesitant to link Hawaii amounts to national levels given Hawaii's experience with gas caps. Mr. Kalapa suggested that it be tied to a percentage of the federal rates. Ms. Niwao asked if there had ever been periods of deflation; Mr. Kalapa cited 1998 to which Dr. Pham added 1999 with respect to the Honolulu CPI but not the U.S. CPI. However the Honolulu CPI is just a byproduct of the U.S. CPI. Regardless, overall, the Honolulu CPI tracks the U.S. CPI, and it is recommended that the U.S. CPI be used.

Regarding forms changes, it isn't just the forms that need to be changed, but the Booklet A Employers' Tax Guide, the ITIMS computer system needs to be updated, etc. Aside from doing the work, there are budgetary considerations as well. Postage charges for new Booklet As, paying the computer system vendor, etc.

Indexing the general excise tax rates was discussed, but Dr. Grandy and Mr. Kalapa pointed out that as inflation rises, so does the tax base for the general excise tax such that inflation is already accounted for.

The Chairman asked about indexing credit amounts too. Mr. Smyth suggested that the indexing of certain credits be considered if tied to some sort of means testing such as the proposed food and medical tax credit. There was no interest on the part of the Commission in considering indexing credits, so only the indexing of the standard deductions, personal exemption, and income tax rates are being considered.

It was moved by Dr. Grandy and seconded by Mr. Okada that the Commission re-recommend that the Hawaii standard deduction, personal exemption, and tax rates be indexed to the rate of inflation. The motion was passed with the following votes: 6Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Lon Okada	Yes
John Roberts	Yes

## 2. Eliminate or sunset tax exemptions and credits.

The recommendation is to have all exemptions and credits be enacted with an automatic sunset date unless the Legislature specifically renews the provision. It was discussed notwithstanding

the Commission's recognition that Dr. Sakai was working on this type of issue with respect to the high technology business investment tax credit and that Dr. William Fox was working on the issue of general excise tax deductions.

It was noted that some credits have been enacted with sunset provisions and then extended, such as the technology credits; others have had the sunset dates repealed and the credit made permanent as in the case in 2006 of the energy credits; and still others have been allowed to sunset such as the home construction and remodeling credit enacted in the wake of 9/11.

Mr. Smyth recollected that the House introduced a bill 5 or 6 years ago to get rid of ALL general excise tax exemptions. When the Finance Committee heard the bill, the room and hallways were packed with all the proponents who represented many different interests – businesses, exempt organizations, etc. These exemptions were sacrosanct.

Mr. Kalapa stated that it is up to the Commission to take an objective look at this issue because lobbyists and other proponents will push for exemptions, credits, etc. The example given was the 1997 exemption for aircraft maintenance for Continental Airlines that was slipped in at the last minute. There was no subsequent review of this credit ensuring that Continental Airlines made 100 jobs permanent.

The Chairman noted that he doesn't mind giving credits and exemptions, but he wants to make sure that the State gets its money's worth. He sees this as a way to ensure accountability by making sure that the provision is reviewed periodically.

The other Commission members generally agreed. Ms. Ching noted that this is what is being attempted with the high technology investment tax credit. Mr. Heller mentioned that ties into a recommendation of the 2002 Commission that sufficient information be provided by taxpayers so that the Department can determine if the State benefited from a credit as intended (cost-benefit analysis). Dr. Grandy stated that having self-reporting by the taxpayers isn't going to have that much value in trying to assess the economic costs and benefits. A sunset may therefore be useful so that those who are for it and those who oppose it can come before the Legislature and periodically revisit the credit; this would be a minimal accountability mechanism.

Mr. Heller agreed that it would force the Legislature to determine if the State is getting its moneys worth for the credit, or at least think about whether the credit should be renewed.

Mr. Kalapa and Ms. Ching agreed that a problem would be how they could determine this without any data. Mr. Smyth cited the hotel and residential construction and remodeling tax credits passed after 9/11 as examples of credits that didn't need to be continued past their sunset dates and that could be tracked based on building permit data, etc. Dr. Pham noted, however, that this credit was problematic as projects that were already in the pipeline benefited from this credit although the credit was not itself an incentive, and that was unfair.

Mr. Heller stated that eliminating all credits and exemptions is going way too far. However, he would like to put forth a motion to include in their report a general recommendation to the Legislature that, in enacting credits and exemptions, in general they should be enacted with a sunset date that will trigger some review of whether or not it should be continued at that point.

Ms. Ching asked if they should include some accountability measures in this recommendation. Mr. Heller stated that he thought it was a separate issue, and Dr. Grandy noted that it would come up later as there was another recommendation regarding accountability.

It was moved by Mr. Heller and seconded by Mr. Roberts that the Commission include in its report a general recommendation to the Legislature that, in enacting credits and exemptions, in general they should be enacted with a sunset date that will trigger some review of whether or not it should be continued at that point. The motion passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Lon Okada	Yes
John Roberts	Yes

4. Establish General Fund Stabilization Fund.

According to Dr. Pham, this has already been done, so this can be skipped.

5. Maximize tax "exporting".

Tax exporting was a big thing for the 1984 Commission. Mr. Kalapa explained that reason for that was because Richard Pollock, a member of that Commission, who wanted to raise the general excise tax and give a credit to Hawaii residents to lessen the impact of the increase in the tax, thereby shifting the tax burden to visitors as included in the Tourism Congress in 1984.

The Chairman noted that the recommendation was a broad recommendation to structure taxes to ensure that they are exported and it is his understanding that they already are exporting a lot of taxes. Dr. Rousslang stated that the forthcoming incidence study addresses this issue, and that he believes it supports his understanding.

Ms. Niwao added as a caveat, except to the extent that nonresidents are not paying their taxes. Mr. Kalapa was asked his position, and stated that the exportation of our taxes is a non-issue because it doesn't take into account the taxes exported to our residents by other states in often-unseen ways. An example is the huge tax on copper imposed by Wyoming that is reflected in the cost of copper plumbing we purchase.

Mr. Smyth stated that another issue is that the federal government pays a bigger share of local taxes in Hawaii than in most other states because of the general excise tax on services and construction, which are not generally taxed elsewhere. In addition, military personnel spend more off base on taxable transactions than in other states as well as what they spend at some of the on-base concessions that are taxed.

Mr. Heller expressed the possibility of perhaps going too far in exporting given the worldwide economy businesses compete in. As an example, people on the West Coast of the mainland U.S. could go to Mexico on vacation cheaper than to Hawaii, and anything that influences the prices in Hawaii will influence that decision. Regardless of the reason prices in Mexico are lower, anything that affects the overall cost equation will tip people one way or the other.

The Chairman asked Mr. Kalapa if he thought Hawaii residents pay more in other states than they pay in Hawaii taxes, and if so, whether that was because the sales tax in other states was higher than the Hawaii general excise tax.

Mr. Kalapa stated that he thought Hawaii residents paid more. There are a variety of taxes imbedded in the price of goods, and some services, that are purchased from other states. Plus, because everything is taxed here under the general excise tax, the cost of doing business and the cost of living will be substantially higher. Mexico is not cheaper just because of cheaper labor, but because they don't carry the tax burden we do.

Ms. Niwao pointed out the high room tax imposed in other places like New York and San Francisco. Mr. Kalapa acknowledged that, but added that in many locations that are not as high cost as New York and San Francisco, the room rates themselves may be substantially lower in Anaheim than those in Hawaii.

The Chairman asked if any in the Commission would like to put forth a motion to re-recommend maximizing tax exporting. No motion was made.

6. Provide direct expenditure assistance, not narrowly targeted tax preferences.

This recommendation actually applied to taxes on businesses. The general consensus was that they would rather have direct assistance (i.e., just give them money) than targeted tax preferences in the form of tax credits. Mr. Kalapa noted that it would be better to lower the tax rates for all businesses instead of targeted tax credits for a specific activity while maintaining a higher rate of taxation on all other businesses.

Mr. Smyth stated that a number of incentives are simply to lower a barrier to give a break to make things equal to other states. The comparison is not with other businesses within Hawaii, but rather to give businesses the same deal that they would have in other states in order to have them come here. That should not be forgotten.

Mr. Kalapa noted that, if that was the case, then we should just exempt services and be equal with other states. Dr. Rousslang reiterated that whenever the barrier for one group is lowered, it is raised for everyone else.

Mr. Smyth stated that, in major studies done by Peat Marwick for New York, Illinois, and at least one other major state, the conclusion was that those states that did not start taxing services would run out of revenue because the old manufacturing base of taxation is being replaced with a service-based economy. Therefore, the wide tax base and low tax rate of Hawaii's general excise tax is better.

Mr. Roberts stated that transparency and accountability support the argument for having direct expenditures. The Chairman noted that this would be taken up in the future with respect to another recommendation.

The Chairman noted that the 1984 Commission's report stated that they didn't think that the total state and local tax burden in Hawaii was out of line with other states.

Mr. Smyth stated that in his experience looking at comparisons of the state tax rankings, there are some 22 different categories of taxes across the states, but the only taxes they look at are the "Big Four": property tax, sales tax, corporate income tax, and personal income tax. They don't look at other taxes such as oil taxes, business and occupation taxes, personal property taxes and many others. He did a study and found that these other taxes can account for as much as 25%-30% of other states' revenues not to mention 100% of Alaska's, is from these other taxes that Hawaii doesn't have at all. This is touted by DBEDT when talking to out-of-State businesses. The result is that we are high when only the Big Four taxes are considered, but we wouldn't be that high if all taxes were considered. Also, per capita tax burden numbers are skewed because they don't count tourists.

Although Mr. Smyth asserted that tourists share our tax burden such that Hawaii residents don't pay all the taxes, Mr. Kalapa states that we are paying all those taxes. He also notes that were it not for the current tax rates, tourists could, perhaps, buy more stuff.

Dr. Grandy stated that he would prefer not to comment on this item. Mr. Roberts added that the earlier discussion of item 2 is broad enough to cover this topic as well.

No motion was made on this recommendation.

### **Recommendations For The General Excise Tax:**

#### **21. Maintain general excise tax structure.**

Discussion on this recommendation was deferred, as it is part of the external study being conducted by Dr. Fox.

18. For general excise tax assessments, the measure of gross receipts should be the price actually paid by the purchaser.

The Chairman asked why this was no longer needed with the implementation of income splitting for tourism-related services. Mr. Kalapa, Mr. Heller, and Ms. Tokishi explained that this goes back a long time ago to an audit conducted on Rudy Choy's catamaran cruise business. Travel agents and other vendors who sold tickets could sell the tickets for any amount as long as a specified amount per ticket was paid to Mr. Choy; the ticket seller retained the amount in excess of the amount paid to Mr. Choy as a commission. Mr. Choy only reported as gross income subject to the general excise tax the net amount paid by the ticket sellers to him. The Department's position was that commissions were non-deductible business expenses and that Mr. Choy needed to "gross up" the reported income to what was actually paid to the ticket seller. The Department used the rack price in their assessment. Although the taxpayer was able to show that the tickets were frequently sold for less than the rack price (discount coupons, free for attending presentations, etc.), the court ruled that Mr. Choy should not have paid the general excise tax on the net amount he received (i.e., the price paid less the commission), and that he should have grossed up his income to the full actual purchase price.

The general excise tax law was subsequently amended to permit "income splitting" with respect to tourism-related services, so no action need be taken by the current Commission.

20. Subject public service companies to the general excise tax and eliminate the public service company tax.

Mr. Kalapa, Mr. Okada, Mr. Heller, and Dr. Pham explained that public utilities and transportation companies paid a higher percentage of their gross income under the public service company tax than under the general excise tax in lieu of both the general excise tax and the real property tax. Post-9/11, the law was amended to shift transportation companies to the general excise tax, where they are taxed as service businesses. Four percent of the gross goes to the State and the balance (which depends on profitability) goes to the counties in certain circumstances. Eliminating the public service company tax would make it difficult for the counties because figuring the property tax due on the small easements for the utility poles and such is very complicated.

No motion was made on this recommendation.

21. Consider a sales tax or value added tax to replace GET.

Discussion on this recommendation was deferred, as it is part of the external study being conducted by Dr. Fox.

**Income Tax Recommendations:**

7. Provide double standard deductions to taxpayers over 65.

Mr. Heller noted that this Commission moved away from providing additional benefits to older and retired taxpayers when it recommended conforming to federal retirement distribution provisions except for a base amount.

Ms. Niwao stated that the last Commission felt that the aging of the population would have an impact although the taxing of interest and dividend income, which were assumed to rise, would make up the difference. Mr. Kalapa also noted an equity issue between the taxation of largely exempt defined benefit plans funded by employers and the largely taxable 401K plans currently widely in use.

The Chairman asked if this Commission, in broad terms, wanted to do something for older and retired taxpayers. Dr. Grandy said he would argue against this recommendation regarding the doubling of the standard deduction. Although the State as a whole is aging and medical expenses are rising, in terms of a broad tax policy issue, he sees this more as an emergency measure. He doesn't see a reason to bestow this tax benefit just because someone reaches age 65.

Ms. Niwao, however, stated that she believes the 7.5% of adjusted gross income threshold for medical expenses that can be claimed as an itemized deduction is too high, noting that it used to be 3% for a long time. Now, many elderly can't take a deduction for their medical expenses.

The Chairman questioned how much benefit the elderly would derive from an additional deduction when the problem is the high costs of drugs. Ms. Niwao related an example of not being able to take a medical expense deduction despite there being a major health crisis.

Mr. Kalapa noted that the lack of a deduction for the elderly may actually be due to the State not taxing pensions such that there is no income against which to take a deduction, but Ms. Niwao stated that the medical deduction provision affects all taxpayers. Mr. Kalapa asked if changing the threshold goes against the general intent to closely conform to the Internal Revenue Code. Ms. Niwao agreed but thought that a lower threshold was warranted in this case, citing anecdotal examples indicating that it doesn't make sense to have such a high threshold. Mr. Kalapa, however, said that it should perhaps be a tax expenditure through a credit as opposed to a change in the definition of gross income. The Chairman agreed.

Mr. Heller returned the discussion to the past recommendation to double the standard deduction for taxpayers over age 65. He thinks that giving it to all of those over age 65 is unnecessary. He'd rather see the standard deduction increased for all to reduce the number of poor who have to pay any tax; it would help a lot of people.

No motion was made on this recommendation.

20. Simplify the filing of income tax returns.

The Chairman noted that this has been done a number of times since 1984. No motion was made on this recommendation.

22. Increase Hawaii individual tax conformity with federal tax.

The Chairman stated that this recommendation had to do with automatic conformity. He called for a motion to have Hawaii income tax conform to the federal.

Ms. Niwao asked if automatically conforming to federal law would affect revenues, and the Chairman acknowledged that it was a revenue impact issue. Mr. Kalapa noted that Hawaii would then be subject to the moods of Congress; they drafted the 1977 conformity legislation to allow the legislators to first determine how the federal changes would affect Hawaii. Prior to 1977, the law adopted public law, of which not everyone had copies, such that nobody knew what was conformed to. The 1977 legislation did it via rejection in sections 235-2.3, HRS, and 235-2.4, HRS.

Ms. Niwao cited as an example the differences in State and federal law regarding depreciation, which has resulted in added difficulty and complexity, although she acknowledged that the federal law went overboard with respect to bonus depreciation.

The Chairman asked how difficult it would be for the Tax Research Office to do its revenue impacts with automatic conformity.

Mr. Hirai noted that several states just take a percentage of the federal tax and then have their own credits, but that would eliminate such things as the pension exemption. Mr. Heller added that it throws a big unpredictability factor in there because the State wouldn't know what Congress is going to do. A federal change, such as another bonus depreciation, could result in a sharp drop in revenues or, as Mr. Hirai noted, the State could raise the rates.

Dr. Rousslang said that it seemed a matter of which legislature the Commission trusted more.

Mr. Kalapa cited the estate and transfer pick-up tax as a good example of the impact of federal law should automatic conformity be implemented as well as its revenue impact.

The Chairman asked if there was any interest in re-recommending this past recommendation. There was no interest expressed and no motion was made.

23. Add back some pension and social security benefits to adjusted gross income.

This issue was previously discussed at the June 27, 2006, Tax Review Commission meeting and a recommendation made at that time.

25. Adopt the alternative minimum tax for Hawaii.

The general consensus of the Commission members was that they did not like the federal alternative minimum tax and did not want it for Hawaii tax purposes either. Mr. Kalapa commented that several members of the 1984 Commission thought that it was a good idea at the time; chief amongst the proponents was Mr. Pollock.

No motion was made on this recommendation.

26. Do not allow any additional special "check-offs" on tax form.

The reverse was done inasmuch as the one check-off for the Hawaii Campaign Election Fund has expanded to also include the \$2 Hawaii Schools Repairs and Maintenance Fund, the \$2 Hawaii Public Libraries Fund, and the \$5 Domestic Violence/Child Abuse and Neglect Funds.

These fund check-offs do not appear to be very successful. Dr. Pham stated that the amount designated for the Hawaii Schools Repairs and Maintenance Fund, for example, was less than \$100,000.

No motion was made on this recommendation.

28. Decouple real property versus personal property provisions for accelerated depreciation rules.

This is irrelevant; the Commission members recalled that it had to do with the very short depreciation period for real property many years ago, which has since been addressed on the federal level and to which Hawaii has conformed.

**Miscellaneous Recommendations:**

14. Establish a state lottery.

Ms. Niwao asked how many states have a lottery. Mr. Kalapa stated that 48 states have a lottery; the exceptions are Utah and Hawaii. Actually, those 48 states allow gambling and most also have some sort of a lottery.

The Chairman asked if lotteries work. Ms. Niwao said that she thought they did, but Mr. Kalapa and Mr. Smyth stated that they tend to be regressive.

No motion was made on this recommendation.

17. Department of Taxation to conduct an annual statistical analysis of the general excise tax.

Dr. Pham stated that the Tax Research and Planning Office provides the statistics, but does not necessarily do an "analysis" of those statistics.

The Chairman stated that the report said that the Department studied income tax but not the general excise tax. Dr. Pham noted that, at the time of this recommendation, information based on the Standard Industry Code (SIC) was unavailable; they are now, so a breakdown of the data by those codes is no longer a problem and is now being done.

7. Modify fuel and liquor taxes to be imposed on an *ad valorem* basis instead of a specific amount per unit.

Note that this recommendation and the next two recommendations were inadvertently skipped and were discussed out of order.

Mr. Kalapa recounted that the State went from *ad valorem* – 40% on tobacco products and 20% on liquor – largely because the liquor industry sued in 1985 over the discrimination of imported versus domestic products.

Dr. Pham noted that fuel tax collections go into the State's Highways Fund. Because the tax collections are based on volume of consumption rather than value, and because the volume has not increased at the rate of inflation, those collections have remained relatively flat despite rising repair and maintenance costs for the roadways.

No motion was made on this recommendation.

6. Establish a mechanism to tax commercial airlines.

Can't tax gross revenues from air transportation based on a U.S. Supreme Court decision and also the Hawaii Supreme Court Panorama Air Tours decision.

No motion was made on this recommendation.

13a. Franchise Tax: Include insurance companies and financial institutions under the corporate tax code, not separate ones.

There was no interest in discussing this past recommendation and no motion was made.

**RECOMMENDATIONS OF THE 2002 TAX REVIEW COMMISSION**

These recommendations had been assigned to Mr. Heller.

**Recommendations For The General Excise Tax:**

2. Do not use exemptions to achieve vertical equity.

The specific recommendation was to avoid targeted exemptions, such as an exemption on food, to avoid the regressiveness of this tax.

Discussion of this past recommendation will be deferred pending receipt of Dr. Fox's study on general excise tax exemptions. However, the Chairman asked if anyone had comments on vertical equity. Mr. Heller noted that everyone recognized the regressivity of the general excise tax and the use of other taxes, such as income tax credits, as a way to mitigate that regressivity. The Chairman noted that, although many states use this technique, it is not very efficient.

14. Clarify exemptions for non-profits for better compliance.

In addition to the two recommendations listed, there was an additional recommendation to tax nonprofits on all sales of goods and services, though not on gifts and contributions.

Ms. Ching asked what was excluded now. It was explained that income from activities directly related to their exempt function would be exempt. Ms. Tokishi further clarified that being nonprofit is not sufficient. The nonprofit organization must apply for tax-exempt status if they qualify (not all types of nonprofit organizations that qualify for income tax exemption also qualify for general excise tax exemption), and if granted, could exempt income that is derived from activities directly related to their exempt function and that do not have as their primary purpose the production of income.

Ms. Ching then asked if this recommendation would tax what is now exempt. Mr. Heller answered in the affirmative, and stated that this recommendation would exempt only pure gifts and contributions.

In response to a question from the Chairman, Ms. Tokishi stated that the determination as to whether an activity is related to the exempt purpose is done on a case-by-case basis. The application organizations file with the Technical Section of the Department for exemption includes income on their revenue-generating activities. The Technical Section, in turn, tries to include information on which activities would generate taxable income in the letter sent to the organization granting the exemption. Once that letter goes out, the organizations don't always come back to ask if additional activities are taxable or not.

The Chairman asked if a profit motive was necessary for the exemption. Ms. Tokishi explained that the exemption only applies when the production of income is not the primary purpose of that activity. She cited a few cases such as the Queen's Medical Center and Habilitat cases. As a specific example, she mentioned that churches that charge nominal fees for weddings may not be taxable, but a church that actively solicits tourist weddings might be taxed.

The Chairman offered the example of a public elementary school that sold tee shirts at cost so that the children were easily identifiable when they went on excursions and such. In such cases, Ms. Tokishi stated that those sales would likely be exempt. Mr. Heller added that, if the shirts were sold for more than a nominal charge as a fundraiser, the sales would be taxable.

Also discussed were activities such as fundraising dinners in which the cost of the dinner was minimal and the balance of the price qualified as a charitable contribution deduction for income

tax purposes. The general excise tax applies to the full amount charged; allowing the portion that qualified as a charitable contribution deduction for income tax purposes would be contrary to the general nature of the general excise tax. The alternative is to charge the lesser amount for the fundraising dinner, and ask participants to separately donate an additional amount.

Mr. Roberts observed that there is a great deal of confusion in the community about this issue and that anytime there is a tax imposed based on the taxpayer's intent they are "walking on quicksand." He sees a need for both clarification and education. Particularly with the smaller nonprofits, even those with rather sophisticated board members, are unaware of these issues and often assume, for example, that being nonprofit automatically means that they are tax-exempt. From an implementation viewpoint, he'd like to see the law cleaned up; either broaden it and let everything be tax-exempt or go to the other extreme and tighten up the definition. He prefers to tighten up the definition.

The Chairman, on the other hand, would rather see it broadened and will work with Dr. Rousslang to come up with clarifying language. Mr. Roberts said that either broadening or tightening up the definition would work, and that it is the middle ground that is problematic. Ms. Tokishi added that one suggestion that has been proposed from time to time is to exempt all income up to a certain amount and tax the rest.

The Chairman suggested allowing all those who apply for their federal exemption exempt all their income and those who do not be taxed on all their income. However, Mr. Kalapa stated that the philosophy behind the general excise tax is that it is for the privilege of doing business. Can't tax a for-profit selling sausage while exempting a nonprofit doing the same thing; there shouldn't be direct competition.

Further discussion ensued regarding whether the unrelated business taxable income (UBTI) standard should be used, but it appears to put for-profit businesses at a disadvantage and is also a complicated standard. Ms. Tokishi pointed out that income tax and general excise tax are two different taxes, and that Hawaii has its own form N-70NP for exempt organizations to report their UBTI.

Returning to the issue of clarifying the definition, the Chairman asked if they should propose something or whether they felt it was too difficult. A straw vote was taken on whether they would rather broaden or tighten the definition; only he wanted to broaden it.

The Chairman and Dr. Rousslang will work on this issue. Dr. Grandy stated that although Dr. Fox's study will address this particular issue, they could still address items 14a and 14b, which do not have anything to do with what they are to be taxed on.

14a. Require general excise tax licenses for nonprofits.

It was moved by Ms. Ching and seconded by Dr. Grandy that the Commission re-recommend that all nonprofits be required to obtain a general excise tax license. The motion was passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Lon Okada	Yes
John Roberts	Yes

14b. Require filing for nonprofits with receipts over \$30,000.

Mr. Heller pointed out that this would be a reporting requirement regardless of whether any tax is due or not. A motion to require the filing of general excise tax returns by nonprofits with receipts over \$30,000 was made by Ms. Ching and seconded by Dr. Grandy.

However, the ensuing discussion questioned why \$30,000 and not some other amount such as \$25,000 required for filing federal form 990. Mr. Hirai mentioned they recommend to their clients that they obtain a general excise tax license, as in 14a, and file the general excise tax annual return to obtain protection under the 3-year statute of limitations provision.

Finally, it was noted that the Commission had already recommended that all nonprofits obtain a general excise tax license and that all registrants are required to file at least the annual general excise tax return. Therefore, this recommendation is moot and the motion was withdrawn.

15. Extend nonprofit exemptions to skilled nursing facilities and for profit hospitals, infirmaries, and sanitarium.

Mr. Heller stated that they might want to defer this item as it may be addressed in part by Dr. Fox's study, but the recommendation was to extend nonprofit exemption to for-profit hospitals and skilled nursing facilities. If for-profit and nonprofit facilities are providing the same type of services, then the same tax treatment should be afforded.

It was asked if there were any for-profit hospitals. Mr. Roberts noted that Maui is debating this issue regarding the planned Malulani Hospital in West Maui. Mr. Hirai noted that St. Francis is being converted into a for-profit, and later pointed out that Straub was one of the first hospitals to become for-profit.

Mr. Hirai stated that the qualifications for exemption must be looked at. If a for-profit accepting Medicare and Medicaid must pay the general excise tax, it would affect the cost, reimbursement rate, etc. The expansion of the general excise tax exemption may be warranted, particularly for acute care facilities, if certain conditions are met such as accepting Medicare and Medicaid, to avoid discouraging capital coming in for those types of facilities so long as they service a certain patient base.

Dr. Grandy stated that this issue seems more to be an access to medical care issue rather than a tax issue, although related. Mr. Hirai characterized it as a health cost issue rather than a tax policy issue per se, and Dr. Grandy expressed discomfort with delving into that area as a member of a Tax Review Commission for that reason.

Mr. Hirai stated that, although he doesn't work with St. Francis, he suspects that the profit margin is very low and that without the exemption it may go under; it was noted by others that St. Francis is apparently already going under.

The Chairman asked if there was interest amongst the members in pursuing this further. Mr. Roberts stated that he is although he understands Dr. Grandy's concern, because of the difficulty in obtaining quality health care on Maui.

Mr. Kalapa noted that it raises concerns from a tax policy standpoint. If the nonprofit exemption is extended to for-profits in this instance, other for-profit businesses may want the same benefit. For example, as we all begin to age, for-profit care homes may want the same benefit. To be nonprofit, there is a provision that states that no benefit shall inure to anybody. If it is a matter of public policy, then it is a matter of direct expenditures to subsidize that service if more health care is what the community wants.

Mr. Heller suggested noting in the report that this recommendation was made by the 2002 Tax Review Commission, and say that this Commission considers it more of a health care policy issue than a tax policy issue and therefore this Commission is not taking a position on it. That was satisfactory to the Commission so no motion to re-recommend this suggestion was put forth.

22. Rewrite the general excise tax law to achieve clarity and transparency.

There was general agreement that the current law is difficult to understand for practitioners and that it needs to be rewritten, but that it would be very difficult to do.

Mr. Heller noted that there is a recommendation further down on the list regarding giving the Department adequate resources to provide appropriate public guidance, and perhaps this could wait until then.

Dr. Grandy said that is only one issue with the Department clarifying what it can, but that it could only go so far as the statute itself is a mess. It would be useful to suggest that it be rewritten, and that, perhaps, the Legislature could assign some of their top bill writers to do this. Another suggestion was to have the Legislature hire a person with a great deal of legal, legislative, and historical knowledge of the general excise tax to re-write the statute. Mr. Heller observed that the statute had been enacted in bits and pieces over the years and that there had never been a comprehensive review.

Mr. Kalapa pointed out that conforming the law to the streamlined sales and use tax agreement would in essence constitute a complete re-write of the general excise tax law.

It was moved by Dr. Grandy and seconded by Mr. Roberts that the Commission re-recommend that the general excise tax law be rewritten to achieve clarity and transparency. The motion was passed with the following votes: 6-Yes.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	Yes
Carolyn Ching	Yes
Christopher Grandy	Yes
Lon Okada	Yes
John Roberts	Yes

### **Income Tax Recommendations:**

#### 10. Change capital gains tax rate.

Dr. Pham pointed out that the maximum tax on net capital gains was not reduced when the top individual income tax rate was reduced from 10% to 8.25%. Mr. Heller stated that there is a much bigger difference between the federal tax on ordinary income and capital gain income than there is for the Hawaii tax.

The Chairman expressed his opinion that the State rate should be decreased to the same ratio as the federal rate. Dr. Pham suggested a State rate decrease from 7.25% to between 5% and 6%. The Chairman stated that it should be the same ratio as the federal decrease had been, but Mr. Heller didn't think that the specific ratio was that important. Dr. Rousslang stated that, in discussions on federal tax reform, they had talked about bringing the rates closer together because of people trying to convert ordinary income into capital gain income.

Mr. Smyth noted that the federal now has a 2-tiered tax. Dr. Rousslang asked if they were correct now or were they correct before. Mr. Smyth stated that they had done a study on other states that found that some states have it at the same level, some at half, and some at 0, concluding that it was all over the place.

Mr. Heller observed that it is unlikely that taxpayers would play games to convert ordinary income into capital gain income due to the Hawaii tax; it was more likely to be done due to the federal tax.

Mr. Kalapa stated that the 7.25% rate resulted because Hawaii did not drop the top rate sufficiently in 1987 as a result of the federal tax reform act and because of a certain large capital gain transaction. Hawaii only dropped its top rate from 11% to 10% while the federal tax treated capital gains as ordinary income. What Hawaii should have done was lower its top rate further as did the federal.

Dr. Rousslang added that an important factor is equity – that is, who gains and who doesn't from a lowering of the capital gain rate – which may be an important reason why the difference is not greater.

The Chairman stated that, based on the discussion, changing the capital gains tax rate really means a lowering of the capital gains tax rate. He asked if anyone would like to move that the capital gains tax rate be lowered; Mr. Roberts moved to re-recommend that the capital gains tax rate be lowered, but there was no second and the motion failed.

17. Eliminate National Guard and Reserve exclusion, political contribution deduction, individual savings account deduction, and child passenger safety restraint credit.

Mr. Heller noted that this had been discussed more broadly before, but this is just a list of specific exemptions and credits. Dr. Grandy suggested that an automatic sunset be recommended; this is actually covered under the earlier discussion of overall tax recommendation 2, so no motion is required on this issue.

Mr. Hirai asked if they had specified a period after which the exemption or credit would sunset because he was concerned that certain credits such as the low-income housing tax credit required a minimum of 10 to 15 years. The Chairman stated that no period had been specified.

30. Overhaul business incentives tax credit process.

Part of this had been covered earlier.

30d. Require beneficiaries of tax credits to file truth and disclosure reports in addition to income tax returns.

Goes back to getting the information needed to do the sunset reviews rather than using it as a disguised way of discouraging people from taking the credits.

Mr. Roberts noted that they would get some feedback on whether there is sufficient information to evaluate credits when they receive Dr. Sakai's study on the high technology business investment tax credit.

Mr. Hirai stated that some of the issues with this are confidentiality issues that prevent the release of data. While he generally agrees with the Chairman that anyone who gets public money in the form of these credits should be required to disclose this information in exchange for getting credits, these are issues and the Commission may need to say something requiring regular reporting annually or whenever.

Mr. Smyth offered the Ko Olina credit as a good example in which information about the credit claims must be provided in a report filed with the DCCA that is separate from the return that clearly states that the report is a public record. This requirement makes it all very transparent.

Mr. Hirai noted a problem if the only thing the taxpayer files is a form with the Tax Department because that is confidential unless, as Mr. Kalapa noted, disclosure is required by law pursuant to *American Hawaiian Cruises*.

For example, Mr. Kalapa noted that the new digital media credit for the film industry does not have a disclosure requirement. How will the public know that the taxpayers' expenditures were subject to the 4% general excise tax?

Ms. Niwao noted that they had been concerned that some taxpayers may be using credits, such as the Ko Olina aquarium and film credits, in lieu of an appropriation. Tax credits are open-ended, whereas an appropriation could set limits and reporting requirements. The Legislature seems to be more inclined to use the tax credits, particularly to benefit particular people or industries.

The Chairman stated that his understanding is that there is a difference in how tax credits and appropriations affect the budget. Appropriations are part of the 5-year budget whereas tax credits are not included as a budgetary item. Mr. Hirai noted that what Ms. Niwao alluded to was the lack of accountability with most tax credits, although that was remedied for the Ko Olina credit because a cap was imposed and a reporting requirement was specified.

Mr. Smyth noted that the reports filed for the Ko Olina credit require the disclosure of the information other than the identity of the taxpayer.

The Chairman called for a motion on this recommendation.

It was moved by Ms. Ching and seconded by Dr. Grandy that the Commission re-recommend that the Legislature require beneficiaries of tax credits to file truth and disclosure reports in addition to income tax returns.

Further discussion was held clarifying that this requirement would apply to all taxpayers and not just individual taxpayers. Mr. Smyth stated that he believes that there are two ways to do this: 1) have the taxpayer agree that the information they provide is not tax confidential; 2) have the taxpayer file a report to say how much they got. The Chairman stated that he would prefer to leave the mechanics broad.

Mr. Heller suggested that this requirement apply to major credits as opposed to credits such as the \$25 credit for buying a child car seat, though it was noted that a receipt is required for that credit. He added that any credit claimed is subject to verification and audit, and this isn't changing this.

Mr. Smyth cited 3 levels of information needed. The first is the dollar amount claimed, and there needs to be a cap on the credit amount as with the Ko Olina credit. The second is who got it. The third is what did they do on account of getting it (e.g., created 10 jobs).

Ms. Niwao stated that these were concerns with the high technology credit. It was open-ended so they didn't know who was going to take it and how much it was going to cost the State.

Mr. Roberts would like future Commissions to be able to engage researchers to do a study on any topic of interest at that time and the researchers could actually get the data without specific identification of the taxpayer. The number and type of taxpayer who claimed an ascertainable dollar amount of credit and created a specific number of jobs; this is the kind of data that should be available but that he does not believe we have at this time.

Mr. Fritz stated that Washington State does not require certification but does require that information be provided to their equivalent of the Tax Research and Planning Office for analysis with studies reported to the legislature. The reports will have the number and type of taxpayers who claimed the credits though not their names, how much was claimed, what benefits were derived, etc. This is what the Commission is trying to do without worrying taxpayers about the loss of their confidentiality, whereas something that would disclose the taxpayer's name, how much the taxpayer invested in which company would be objectionable.

Mr. Roberts noted that in a small community such as in Hawaii, it is possible to in some cases identify the taxpayer, but that is not sufficient reason to prevent the collection and reporting of the information in the manner described for Washington. Mr. Hirai asked about the mechanism for releasing the information for that specific purpose. Mr. Fritz replied that the law contains a provision requiring the information for the purpose of evaluating the credit and the effectiveness of the credit, but it doesn't go so far as to disclose who the taxpayers are.

The Chairman asked if the current motion is broad enough to communicate their intent while leaving the mechanics to the legislators. The intent being to require the beneficiaries of the income tax credits to file these reports

Mr. Hirai suggested taking a closer look at the Washington provisions because that would seem to be the way to go. The Chairman deferred further discussion and action to the next meeting

#### **LIST AGENDA ITEMS FOR THE NEXT MEETING**

The next Tax Review Commission meeting will be on August 29, 2006, at 9:00 a.m.

#### **ADJOURNMENT**

It was moved by Mr. Heller and seconded by Mr. Okada to adjourn the meeting at 11:50 a.m. The motion was carried unanimously.