TAX REVIEW COMMISSION

MINUTES OF THE FOURTEENTH 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, JUNE 27, 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, June 27, 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 (arrived late)
Melanie King, Bank of Hawaii (arrived late)
Lon Okada, Hawaiian Electric Industries, Inc.
John Roberts, Niwao & Roberts, CPA's

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

Other: Craig Hirai, Bowen Hunsaker Hirai
Lowell Kalapa, Tax Foundation of Hawaii
Diane Erickson, Dept. of Attorney General
Johnnel Nakamura, DOTAX
Joseph Tichy, DOTAX

CALL TO ORDER

Chairman Isaac Choy called the meeting to order at 9:03 a.m. with a quorum present.

APPROVE MINUTES OF MAY 30, 2006, MEETING

Mr. Roberts asked that the draft minutes be amended on page 8 to insert "be considered" in the paragraph regarding Mr. Kalapa's comments regarding large landowners.

Mr. Heller asked whether it was necessary to summarize the suggestions from the public that were discussed at the previous meeting, as the information was detailed in the minutes. The Chairman noted that there is no problem having the information in both places. That being the case, Mr. Heller noted that a change should be made to the agenda regarding item 5, line 5, which should read, in part, "compliance by out-of-state lessors." [Emphasis added.] The change was noted.

It was moved by Ms. Ching and seconded by Mr. Heller to approve the minutes of May 30, 2006, as amended. 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 asked that commissioners read Dr. William Fox's study, *Implications of the Streamlined Sales Tax Agreement for General Excise Tax Revenues*, which is posted on the Office of the Auditor's website, and, *Should the Hawaii General Excise Tax Look Like Other States' Sales Taxes?* in the Report of the 2001-2003 Tax Review Commission. He also suggests that commissioners read 2006 testimony (5 including the Department's testimony) on the Streamlined Sales and Use Tax bill. Persons who have expressed an interest in attending the August meeting include Senator Carol Fukunaga, R. J. Yahiku, and Craig Hirai.

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 TRC will evaluate the results from its external studies at the meetings to be held in August (after the preliminary reports are due) and October (after the final reports are due).

The Chairman observed that there are many things coming up, and therefore hopes to finish the review of all the statutory and administrative changes at this meeting; if not, the Commission will finish it up in July. He also reminded the Commission about the folder he is assembling as a reference manual for their final report.

DISCUSS THE INTERIM REPORT ON THE INTERNAL STUDY ON "TAX ADEQUACY"

Mr. Heller asked that an executive summary be included at the beginning; perhaps a couple of paragraphs on what this is about and what the conclusions are because it is too academic for most readers in its present form. He also asked about the statement on page 3, in column 3 near the bottom, which states that it does not appear that there was any strong secular trend since 1980, but it went down and then came up, and there has been a steady increase in government spending. Dr. Rousslang explained that the difference between the two lines is basically the unemployment contributions and unemployment payments such that the general fund (basically for the operations of the State) was fairly flat. But the period between 1990 and 1995 was a period of recession and government expenditures went up; when the economy slowed down, unemployment insurance payments went up. Dr. Pham further explained that welfare payments were a factor, but that money was from federal government rather than State revenue. Mr. Heller suggested that this be explained, and Dr. Pham agreed to review this section.

Mr. Heller and Mr. Okada forwarded additional comments and corrections to Dr. Rousslang. Mr. Roberts stated that he didn't feel that they had answered the question. Whether Hawaii's tax structure is adequate or not, according to Dr. Rousslang, depends on what you mean by "adequate". If you think that tax revenues should grow automatically at the same rate as personal income, then the structure is adequate IF it continues to behave in the future as it has in the past; it may not.

Mr. Roberts stated that he had previously raised the issue of whether this should be considered or not because of past difficulties in doing so. While he no longer is as opposed to this study as he was then, he wonders if it is detailed enough or broad enough to include such things as whether the Department has the resources needed to implement the tax system. However, continuing this line of thoughts leads to a "quagmire" in that the study becomes too complex. Nonetheless, he'd like the study to end with a definite yes, no, or "maybe because of the following assumptions"; we need to help the reader out by telling them.

Dr. Pham explained that the Commission had earlier asked for an update on James Mak's study, and they had therefore followed his format. There is no way to know if government services are sufficient.

Mr. Okada observed that staffing was an operations issue rather than a tax system issue, and therefore should not be causing any confusion.

The Chairman asked if the Commission wanted to answer this question. Mr. Hirai and Dr. Pham thought that answering this question was required by the constitution – the growth rate of government spending cannot be higher than the growth rate of total personal income; that's why staff use income. This is just an update.

Mr. Heller noted that the conclusion is in the report; it just is not very clear that the answer is yes, given the definition of "adequate" stated in the report.

Dr. Pham noted that he believes that the gross domestic product (GDP) is a better measure than income. However, income is a measure published by the federal government (U.S. Bureau of Economic Analysis) and is seen as less biased than the GDP published by states. As Mr. Heller noted, the bottom line is that the State does not have a tax adequacy problem.

The Chairman does not agree with the language in the introduction with respect to people agreeing how much to consume and how much to pay in taxes. Except in the collective sense, individuals don't generally agree how much to pay in taxes; the term, "agree" is problematic. Same problem with the next sentence with respect to a bad system inflicting pain and causing people to choose to pay less in taxes; some people pay no taxes or very little taxes and thus don't experience the same pain. According to IRS statistics, the top 50% of the population pays 96.5% of income taxes. Is that a poorly designed system?

Dr. Pham pointed out that those numbers reflect the income tax. In Hawaii, however, the GET is the main generator of tax revenue and is regressive. The Chairman disagrees with the usage of the terms "agree" and "choose". Dr. Rousslang pointed out that this is based on the premise that the government is representative of the people.

The Chairman also asked if "tax revenues" and "tax collections" in column 3 are being used interchangeably; they are. There is a distinction between tax revenues and tax liabilities. Note that all these numbers are cash basis.

On page 3, column 1, the Chairman asked if it was correct to say that "taxes account for about 90 percent of all General Fund Revenues," and how the $7,095 million derived. Dr. Rousslang explained that although tax revenues constitute the bulk of General Fund Revenues, income other than taxes also go into the General Fund. As for the $7,095 million, there are some funds that don't go into Governmental Funds and he'd have to get back to them on that.

In reading the studies, the Commissioners will need to read everything carefully; maybe not all the statistics but the assumptions.

Mr. Okada stated that he doesn't understand what Table 4 is. Dr. Rousslang explained that these are constant law collection numbers not real numbers; they are the numbers calculated as an exercise under the assumption that the law doesn't change over time.

Mr. Roberts said that the study language could be more technical, but it is up to the Commission to translate them into something more understandable in their report.

Before going on to Agenda item 5, a draft list of the Acts implementing past TRC recommendations prepared by Ms. Tokishi was distributed as requested by Mr. Heller to assist the Commissioners in their review of recommendations made by past Commissions (see agenda item 3b). Mr. Roberts noted that it would be a good idea to incorporate the original table into the format used for the list of Acts if possible.

CONTINUE EVALUATING SUGGESTIONS FROM THE PUBLIC

Before continuing, Dr. Rousslang noted that completing the items on the agenda would leave items 21, 39, 43, and 50 from the list of outside recommendations, and those require additional information from the internal and external studies.

<u>35. The Department of Taxation should review the certification process for the high tech credit – it now comes in the middle of the year.</u>

This suggestion was received from Stacy Hadano.

Ms. Nakamura reiterated her comments from the previous meeting that the statute specifies the March 30 due date, which cannot be extended, and that taxpayers need to get the certification back before their return due dates. The Chairman asked if an extension could be provided for by rule, but Mr. Heller stated that it probably couldn't because the rule would conflict with the statute; a statutory change would be needed.

Ms. Ching noted that this time of year is bad for the Department as well as practitioners. She currently still has an application pending; however Ms. Nakamura said to follow up with her as it was her understanding that all of the certifications had been completed.

Mr. Heller asked if the Commission should recommend a statutory change to allow extensions. Ms. Nakamura noted that allowing extensions would mean that the taxpayer's tax return also would need to be extended. Mr. Okada asked about all those taxpayer who don't want to extend. The Chairman noted that most of those claiming the investment and research credits probably file extensions anyway as they were the more complex returns rather than the "mom and pop" type returns. Ms. Ching disagreed; she has a number of small clients who would rather not extend their returns.

Ms. Nakamura said that filing an extension would have to be optional, but that filing an extension for the certification almost certainly would require an extension for the taxpayer's return.

Mr. Heller asked if it would make sense to have a box on the return extension form to simultaneously apply for a credit extension? However, it was pointed out that the filing deadlines are different and that the extensions are for two different taxpayers.

The Chairman asked if they should recommend that the deadline be the same as that for income tax return filing. Both Mr. Heller and Ms. Nakamura stated that the relationship between the March 30 certification deadline and the April 20 tax return deadline should be maintained for certification extensions.

Ms. Nakamura also noted that there was a problem with the March 30th deadline as it should be March 31st instead; perhaps they could recommend fixing that at the same time.

<u>It was moved by Mr. Roberts and seconded by Mr. Heller that the Commission recommend changing the statute to allow for an extension for the high technology certification. The motion was passed with the following votes: 5-Yes</u>.

The Chairman called for the vote:

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

<u>42. Revise Hawaii's adoption of IRC 1031 to require that the qualified replacement property be situated in the State of Hawaii</u>.

Decision-making on this suggestion had been deferred to allow time to find out what other states do and their experience with it.

Dr. Rousslang reported that Georgia does what is being proposed unless both properties are located out-of-state; Connecticut, Delaware, Louisiana, and Missouri also do what is being proposed. He deferred discussion on California's provisions. Ms. Nakamura said that she thought that some states had adopted such a provision but switched back after a few years; Dr. Rousslang did not have that information.

The Chairman asked if adopting this recommendation would be administratively feasible in Hawaii. Ms. Ching asked if the Chairman was referring to nonresidents only since they do not report worldwide income, and it was suggested that such a provision be for nonresidents only. However, Mr. Heller said that there might be a constitutional issue if we tax nonresidents differently.

Mr. Roberts asked why Dr. Rousslang did not discuss California. Dr. Rousslang explained that the discussion about California actually had to do with a separate issue on withholding and that California does not require replacement property to be in California.

The Chairman asked if any resort states had such a provision (no) and what the administration's position on this was (no position).

Mr. Roberts mentioned that Mr. Kalapa had raised an issue at the last meeting with respect to large landowners and how that might impact the rental market. Mr. Okada asked Mr. Kalapa to clarify the rental issue.

Mr. Kalapa explained that the Campbell Estate has for years used section 1031 to swap undeveloped Hawaii land for developed mainland land. That allowed them to reduce the cost of lands to developers of residential or nonresidential property. Imposing this restriction would make Hawaii a less attractive place for nonresidents to invest in and would stymie economic development in the State because Hawaii is a capital-poor place. Whether it is the Campbell Estate or nonresidents, they may take their capital elsewhere if Hawaii disallows 1031 exchanges for non-Hawaii property because it restricts the options that people have, and therefore increases costs of doing business in Hawaii.

Mr. Hirai said that it would make Hawaii a less attractive place to do business. If someone on the mainland does a 1031 into Hawaii, then they may want the option of doing another 1031 out of Hawaii. Limiting it to nonresidents may seem okay if the assumption is that Hawaii residents who do a 1031 exchange for out-of-State property will eventually pay Hawaii tax on the gain, but residents could subsequently move out-of-State and never pay taxes on gain that was built up here.

Mr. Roberts indicated that, since real estate appreciation is not linear, it might be too late to impose such a change after 10 years or so. Mr. Okada thought that this requirement had previously been part of a bill; Mr. Kalapa stated that it had been in the mid-1990s.

<u>It was moved by Mr. Heller, for purpose of taking a vote, and seconded by Ms. Ching that the Commission adopt a 1031 exchange rule for Hawaii that requires the replacement property to be situated in the State. The motion failed with the following votes: 1-Yes 4-No 2-Abstain</u>.

The Chairman called for the vote:

Isaac Choy	Yes
Ronald Heller	No
Carolyn Ching	Abstain
Christopher Grandy	Abstain
Melanie King	No
Lon Okada	No
John Roberts	No

<u>45. The new ITPS Online Transaction List software system does not provide important data needed by practitioners and taxpayers regarding the breakdown of each tax payment made.</u>

Dr. Rousslang read the original suggestion 45, which was submitted by Marilyn Niwao.
Mr. Roberts recalled that one of their managers had tried to reconstruct the tax payments of the taxpayer, but upon calling the Department, was told that the data that they used to be able to retrieve was no longer readily accessible and that it was a laborious process for the Department representative to obtain that information. The Department representative did it, but it took a while. It involved breaking out principal and interest.

The Chairman asked if everyone was familiar with the IRS e-services program for practitioners who e-file over 100 returns. It allows the practitioner to obtain taxpayer account information, online. He asked if the Department had something like this program.

Ms. Tokishi stated that obtaining payment information, including the breaking out of the interest, could just be a timing thing having to do with the Department's conversion from its old computer system to the new if the information was on the old system and converted into the new system.

In that case, it could have taken more time to reconstruct. However, this should not be a problem at present as the systems have been fully converted. As for the IRS e-services program, the Department does not offer the same type of program at present.

The Chairman asked if the Department planned to do so in the future. Ms. Tokishi did not know; it may require additional system enhancements. Dr. Pham noted that a bill to fund further enhancements to the ITIMS system did not pass during the last Legislative Session.

Ms. Ching asked Mr. Roberts if it was a prior year or current year. Mr. Roberts was not sure, but thought it may be a current year. Mr. Roberts stated that the problem seemed to be the allocation of the principal and interest, and that the representative had to manually calculate it and get back to them 24 hours later. Ms. Ching expressed surprise, because when they get notices of delinquency, everything is broken out.

Ms. Tokishi indicated that it should not have been a problem under the current system; perhaps if it was in the old system or partly in the old system, but not if it is under the new system.
Ms. Tokishi asked if it involved income tax or general excise tax. Mr. Roberts stated that he thought it was a combination of both, and that the representative had to manually calculate it and get back to them 24 hours later. If so, it could have been more difficult because those systems converted at different times.

Dr. Grandy asked how old the current system is. The general excise system was converted in October 2004 and the income tax system the year before that.

This should not be a problem under the new system, particularly with respect to the allocation of a payment between the income tax and the general excise tax since both are now part of a single integrated system instead of two separate computer systems.

If the issue is moot, Mr. Roberts suggested that the Commission move on to the next item. The Chairman agreed; no motion is required as this is just a matter of the system getting better and better.

<u>46. The Department of Taxation should be able to retrieve and correct the misapplication of payment without the document locater number (DLN).</u>

Mr. Roberts stated that this was related to number 45, but he is not familiar with this.
Ms. Tokishi indicated that, with the new system integrating the income and general excise taxes, what was almost impossible to do under the old system is now easily done. The Commission decided to assume that it is fixed; no further action taken.

<u>47. Make the new Hawaii computerized forms more readable so practitioners and taxpayers can identify and correct error.</u>

Dr. Rousslang noted that this suggestion was also submitted by Marilyn Niwao.

The Chairman agreed that the new scannable Forms N-11 and N-15, and general excise and withholding tax forms are hard to read. He asked if the Department had received good comments about them. Dr. Pham and Ms. Nakamura believe that the Department is looking for ways to improve the forms.

Mr. Heller commented that, in the process of making it easier for a machine to read the forms, the Department made it harder for people to read them. They also don't copy well.

Mr. Kalapa and the Chairman asked if, based on that morning's paper, they are being machine read. The Department representatives present were unsure, although Mr. Kalapa said that his understanding was that it would not be until August. However, the Commission's comments as to their unhappiness with it have been noted, but they hope it will get better as time goes on.

Mr. Roberts summarized the discussion as follows: Making the form machine-readable should not be at the expense of the form being human-friendly.

<u>48. Hawaii should consider legislation relating to "tax deposits" similar to IRS code section 6603 and California Revenue Taxation code section 19041.5.</u>

Dr. Rousslang read the original suggestion 48 from Charles Rettig that legislation be proposed to allow taxpayers to make a deposit against a future tax liability to stop the continued accrual of interest, which can be significant in lengthy administrative proceedings. Unlike payments against established tax liabilities, taxpayers can retrieve these deposits. While a matter is open, Hawaii cannot receive full or partial payment against that potential liability.

Ms. Nakamura stated the problem the Department has with 6603 is that the IRS pays interest on the deposit if it is not applied and that the federal interest rate varies with the prime rate. Hawaii's interest rate is a flat 8%. The concern is that, depending on the going bank rates, taxpayers could "invest" with the Department and get the 8% rate.

The Chairman asked for clarification on what IRC Section 6603 is. Ms. Nakamura said that it was the old bond posting provision under Rev. Proc. 8856.

The Chairman asked if a Hawaii taxpayer could make a payment if they filed an appeal. For example, they could pay under protest. Ms. Nakamura said that there are ways to do it, but you don't get interest if you pay under protest. Mr. Heller further clarified that, if you pay under protest, you'll only get the money back plus interest IF you prevail.

One big difference between the payment under protest and the voluntary deposit under the IRC is that you could go back to the IRS 6 months or a year later and say that you've changed your mind and need the cash and the IRS will give it to you. With the State, the only time you'll get it back is if you prevail.

The Chairman noted that, if you don't prevail, then at least the State has the money so no further interest has accrued. Ms. Nakamura agreed, but said that what Mr. Rettig is suggesting is better than paying under protest since you could withdraw the money with interest at any time during the proceeding.

The Chairman said that, for purposes of making a motion, it should read that the State should conform to IRS Section 6603.

Dr. Grandy asked if it wouldn't accomplish the same thing if the taxpayer just deposited the money into an interest bearing bank account to offset the cost of the interest assessed by the State. Ms. Nakamura explained that the problem is with the different interest rates; for example, if the bank's interest rate is 2% while the State's rate is 8%.

The Chairman also noted that penalties stop when the State receives the money as well. Penalties could be higher than assessed interest, but not always. Mr. Heller noted that most penalties are capped at 25%, while interest goes on forever.

Ms. Ching asked if the 8% rate was a statutory rate; it is. Mr. Kalapa stated that, back in 1970's the State considered doing the same thing as the feds, but the technology hadn't caught up so the Department resisted a floating interest rate.

The Chairman asked if a floating interest rate would take a lot of overhead for the Department. Mr. Kalapa said that there are programs that should be able to do this. However, the Chairman said that, administratively, it would take more effort than a flat rate.

Mr. Heller stated that there was just a GAO study that found that the IRS incorrectly computed interest 40% of the time. The Chairman stated that this is the reason why many practitioners buy the T-value of money program to compute penalty and interest.

The wording of the motion was discussed with respect to the interest rate. It currently is statutorily fixed at 8% and that is problematic. It was assumed that the State would set a rate much less than the present 8%. Ms. Tokishi pointed out that it applies by statute to both interest paid and interest assessed. Ms. King stated that it sounded as if the interest rate is unlikely to change; that is not the case, but since it is statutory it would be difficult. Mr. Heller said recommending this change would only make sense if the Department moves to a floating interest rate. Dr. Grandy suggested that it include language such as, "provided that the State move towards using a market-based interest rate."

Dr. Pham asked what is meant by, "market-based"; the Commission will leave that to the economists.

<u>It was moved by Mr. Roberts and seconded by Ms. King that the Commission suggest that Hawaii conform to IRC section 6603, provided the State use a market-based interest rate. The motion was passed with the following votes: 6-Yes 1-Abstain</u>.

The Chairman called for the vote:

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

<u>51. Require all GET, TAT and Rental Motor Vehicle (RMV) taxpayers and all employers to file their tax returns (whether monthly, quarterly or semi-annually) on the scheduled deadlines with or without their payments.</u>

Dr. Rousslang read the original suggestion 51 from Mr. Howard Karr. The reason given was his belief that a number of filers who cannot pay the tax owed don't file the return. As a result, the tax owed is not reflected in the Department's monthly statistics. In addition, no tax liability is reflected and the Department does not pursue the past-due taxes.

Mr. Okada asked if taxpayers weren't already required to file their returns regardless of whether payment is made or not. The Chairman said that, although taxpayers are required to file, the statistics are kept on a cash basis rather than an accrual basis; that is, they reflect actual tax amounts paid rather than what should have been paid. He further explained that Mr. Karr has served on various committees that do economic forecasts and that's why he wants an accrual-based number. However, the Department has apparently not enforced this filing requirement.

Ms. Ching asked how this could be enforced. The Chairman agreed that it should be enforced. If a taxpayer is required to file a report and doesn't, the State should be able to send out a notice of nonfiling. Ms. Ching stated that she receives notices for her clients when they apply for an extension. Mr. Karr appears to want the Department to be more proactive.

Dr. Pham noted that the statistics also reflect payments made without a return being filed, and while the Department may know what tax it is for, it cannot be allocated to one activity or the other without the return.

The Chairman noted that the Annual Report reflects the cash basis accounting as it shows total revenues, from which refunds are subtracted to arrive at net revenues. Theoretically it sounds good, but it is not how it is done from an accounting standpoint. He asked if the State would ever move to an accrual system. Dr. Pham stated that there is a provision, Governmental Accounting Standards Board (GASB) Statement No. 34, but he is unaware of any state implementing it.

Mr. Roberts stated that having an off balance sheet accrual system might provide an impetus for increasing compliance activities and force this into the public domain better.

The Chairman stated that there are basically two groups as far as uncollected taxes goes; those who didn't file (in which case the Department can only guess at how much may be owed), and those who did file but didn't pay.

Mr. Heller stated that the problem is that there are taxpayers who can't pay and who therefore avoid filing a return which would alert the Department that tax was owed. What is needed is an incentive for them to file even if they can't pay, such as lower penalty exposure. Ms. Tokishi mentioned that there is such a thing. The Chairman recalled that there is the failure to file penalty of up to 25%, as well as the 20% failure to pay penalty. However, Mr. Heller observed that there is little difference in practice – the Department typically just imposes one 25% penalty for failure to pay and failure to file.

The Chairman asked if anyone knew why cash accounting is used rather than accrual. Dr. Rousslang posited that in choosing between cash and accrual, the accrual method didn't always work because taxpayers left or went belly up and the revenue was never realized. The Chairman said GAAP would take care of it. Mr. Kalapa said that, going back to the 1970's and 80's and the Ariyoshi years, if you didn't have the cash you restricted spending.

The Chairman suggested that the Commission recommend the use of GAAP, although that would be unlikely. Mr. Roberts suggested that if the Legislature were given an accrual accounting statement, they'd spend it.

Mr. Heller returned to the core issue and stated that this suggestion doesn't require any action because everyone is supposed to file their returns on time even if they can't pay.

The Chairman asked if using proper accounting would be more efficient or be too much work? Dr. Grandy stated that in 1998 one of the components of ERTF was to move to GAAP accounting. The result was that it was a good idea and should be done, but it was not implemented.

Mr. Kalapa stated that this suggestion ran into the same problem that the public service company tax had. That is, the public service companies paid on the prior year income, until 9/11 when all except the utilities were moved to the general excise tax because they couldn't pay based on the previous year's high income. So accounting does make a difference as to how people react to the tax law.

The Chairman also noted that, when doing revenue forecasts and expenses, you'd only be guessing. No further action needs to be taken on this matter.

<u>52. Match, on a monthly basis, the Hawaii Tax I.D. number for all GET, TAT, and RMV taxpayers and all employers to ascertain whether the necessary forms or payments are being made on a current basis.</u>

The Chairman asked what RMV stood for. It was explained that it was the Rental Motor Vehicle and tour vehicle surcharge tax; the daily surcharge when vehicles are rented and the monthly per vehicle surcharge on tour vans and buses.

No further substantive discussion ensued as it was similar to item 51.

<u>23. Reduce or eliminate the State's gas tax for a given period of time.</u>

This suggestion was submitted by Mr. Joe Wikoff. Dr. Pham stated that now that fuel has 10% ethanol, there is a temporary general excise tax exemption in place until the end of the year. That's not the fuel tax, but the fuel tax is needed for the federal matching funds for the highway fund. If the fuel tax is reduced or eliminated, the State would lose the federal matching funds. Also, while general excise tax collections on fuel sales may have risen as the price of fuel has increased, at least prior to the addition of ethanol, fuel taxes are based on volume rather than price.

Mr. Kalapa mentioned that it had been suggested in 1979 that the fuel tax be changed to an ad valorem tax.

<u>37 and 44. Examine differences in the tax treatment of pensions that are funded by employer vs. employee contributions. Pension income is not applied even-handedly as it distinguishes unfairly between one type of retirement income and another.</u>

The Chairman noted that he had just received his first notice from the Department questioning the taxability of retirement. The 1099s do not reflect the Hawaii taxable amount. The suggestion is to exempt all retirement income or tax all retirement income; taxing all would be unpopular.

Comments regarding the difficulty of determining whether amounts were rolled over into an Individual Retirement Account (IRA) or not, tracking distributions when contributions from different sources are co-mingled, tracking exempt 401(k) employer matching contributions, etc., were made in support of the need for change.

Dr. Grandy stated that the 1997 Commission had recommended looking at this issue and recommended taxing all pension income. However, the last Commission concluded that the effect of the current position exempting certain pension distributions would decrease over time because, in general, people were moving towards taxable retirement vehicles.

Mr. Hirai stated that they were looking at this as a revenue adequacy matter; that, as Baby Boomers retired, would there be a revenue shortfall if all their pension distributions were exempt. However, the study found that almost all the newer retirement vehicles were taxable.

Mr. Hirai pointed out an equity issue with respect to why a six-figure retirement distribution was not taxed when a family of four with $40,000 of adjusted gross income is taxed. Mr. Heller noted that there also is an equity issue with respect to people who made a decision to stay in Hawaii because they were told it was exempt and asked if a grandfather clause should be included.

Mr. Hirai also noted that many government employees are not getting large pensions and are counting on them not being taxed.

The Chairman asked for comments on his belief that Hawaii didn't tax pensions because it wanted to attract retirees who would not use our government services but would spur the economy.

Mr. Kalapa stated that this is not quite the case. The Kaiser Amendment, the provision that only taxed Hawaii-sourced income from if the taxpayer moved to Hawaii and became a Hawaii resident after attaining age 65 and who did so before July 1, 1976, was enacted to attract Henry Kaiser to Hawaii; Mr. Kaiser, most of whose income was from out-of-state, subsequently moved here. The State wanted to attract nonresidents to retire in Hawaii by giving them that exemption on out-of-state income regardless of whether it was pension income or not. Secondly, there is a dichotomy between government pension distributions that are specifically exempt and private pensions that are increasingly taxable. A middle-ground position would be to exempt a certain base amount and tax everything above that amount.

The Chairman asked if the original premise for wanting retirees to come to Hawaii still stood. Mr. Kalapa noted that a study in the mid-1980's concluded that retirees actually used more government services.

The Chairman asked if the Department was capable of determining what was taxable and what was not and enforcing it. There was no comment by the Department personnel present. However, Ms. King noted that the Department does not have the information needed to determine the taxable amount.

The Chairman stated that he thinks this is something that the Commission should vote on, and suggested that the motion be that Hawaii should have uniform tax treatment of retirement income. Mr. Okada asked how the Chairman would define "retirement income." The Chairman stated that it would include everything from IRAs to 401(k) plans, to defined benefit and defined contribution plans – everything under IRC section 401 etc.

Should it be that Hawaii should tax all retirement income or not tax any retirement income? Dr. Grandy would not want to exempt all retirement income. Ms. King would prefer exempting a specific base amount. Mr. Heller asked about regular IRAs and Roth IRAs; will they just follow federal law?

The Chairman noted several problems. First, the only people who know what is taxable and what is not are the taxpayers, not the Department. This makes the present provision non-administrable. Second is the revenue loss issue. Third is the attraction of people on retirement income to Hawaii.

The Chairman summarized by saying that they want uniform treatment, perhaps as Dr. Grandy had noted, to tax all retirement income. However, Dr. Grandy acknowledged the issue raised by Mr. Heller regarding people who had made plans based on implicit promise not to tax, so if there is a move to tax all retirement income, there has to be a lot of notice with a long transition period.

The Chairman noted that people could decide to move. Mr. Roberts said that the transition period would have to extend back to when people took their first job here if people made career decisions. The Chairman noted the difficulty in tracking this and suggested that Mr. Kalapa's suggestion to exempt a base amount would be a preferable option.

Mr. Hirai suggested that from a technical standpoint, if Hawaii conforms to the federal, then perhaps they could consider an above the line deduction to implement the base amount suggested by Mr. Kalapa.

The Chairman asked if the amount would be a percentage of the retirement income or a percentage of adjusted gross income? It would be a set dollar amount. The Chairman asked for suggestions as to how much this base amount would be. Mr. Okada suggested leaving the amount blank, but the Chairman stated that they should suggest a number to provide guidance to the legislators. Dr. Grandy asked if they should be writing the proposed legislation by providing a dollar amount for the tax-exempt base. However, Mr. Hirai agreed with the Chairman that, while it makes sense to leave the amount blank from a policy standpoint, experience has shown that, from a practical standpoint, they need to provide a number that the Legislature can start with if they want the Legislature to act on the suggestion.

Ms. King suggested a range of $40,000 to $60,000. Mr. Hirai suggested that it be indexed to inflation. It was agreed to use $50,000 as a specific suggestion.

Dr. Grandy asked if they wanted to make this a permanent feature of Hawaii tax structure or just a transition step that he would prefer towards full taxation.

The Chairman asked if a bill to tax all pensions had been considered at all previous legislative sessions without making it out of committee. Mr. Kalapa stated that it had been introduced occasionally but not consistently. The Chairman recalled that the strategy had been to start taxation at a very high level of income so that it affected few people and then ratchet it down from time to time. Mr. Hirai recalled a 10-year phase-in.

Mr. Kalapa felt that Dr. Grandy's suggestion to make a general recommendation was better.

Language for the motion is for Hawaii to conform to the federal tax treatment of retirement income with consideration of a base exclusion. Ms. Ching asked if there was to be grandfathering. Mr. Heller asked if there was to be a separate grandfather clause or whether the inclusion of the nontaxable base amount was how they were accommodating the grandfathering. They agreed that the base amount was the grandfathering.

Further discussion was held as to whether that base amount was an exemption, which could have different amounts based on filing status, a deduction, or an exclusion. The mechanics are that it would be a deduction, but if it is like certain amounts paid to members of the reserves or the

Hawaii National Guard under §235-7, HRS, then it is properly an exclusion. This is just a matter of thinking of the statute versus thinking about the form.

Ms. Ching expressed further concern with the lack of a specific grandfather clause. The Chairman stated that the exclusion should cover the low-income taxpayers. Mr. Kalapa noted that this was the concern of the Legislative Reference Bureau study; is this segment of the population paying their fair share since they are using government services (anything from the handivan to health care services, etc.). The ones making a lot less are the ones using these services; the wealthier ones are not because they can pay for their own private services.

Dr. Grandy suggested that, should the Legislature take up this issue, they will certainly address many of the concerns being discussed at the meeting, so it may not be necessary to resolve them here. Mr. Kalapa also noted that there was no grandfather provision when the Kaiser Amendment was repealed. Mr. Hirai also noted that someone with a $200,000 retirement who gets the first $50,000 excluded will not find the Legislature sympathetic to his argument.

<u>It was moved by Ms. King and seconded by Mr. Okada that Hawaii should conform to the federal tax treatment of retirement income with consideration of a base exclusion amount of $50,000. The motion was passed with the following votes: 6-Yes 1-Abstain.</u>

The Chairman called for the vote:

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

<u>38. Adopt withholding taxes for nonresident partners of Hawaii partnerships.</u>

Suggestion 38 was submitted by Ms. Marilyn Niwao. Mr. Roberts has seen too much anecdotal and circumstantial evidence that nonresidents are not paying their fair share and there must be some mechanical way to get it done.

Mr. Heller asked if this was partnership specific. Mr. Roberts noted that the Commission had previously discussed S-corporations but his concern was with all pass-through entities, though he's seen more with partnerships. Mr. Hirai asked about foreign partnerships registered to do business here; Mr. Roberts had not considered that scenario.

Although he is for this measure, Mr. Roberts expressed concern about what the impact would be, whether it would discourage investment here. Dr. Grandy stated that, in theory, they are liable now, so if there is investment taking place on the presumption that the investor will be able to avoid the law, is that something desirable? As restated by Mr. Roberts, is our gray economy better than theirs and are our loopholes bigger?

Mr. Heller stated that, if the State is to have a withholding requirement, there must be some teeth in it. The real change is to have some consequences on the pass-through entity for failing to pay the taxes. Ms. Ching stated that federal law imposes penalties on the partnership for failing to withhold on the foreign partners.

Mr. Hirai asked if Mr. Roberts was referring to real estate or operating businesses. People often use losses from one pass-through entity to offset gains from another. If you're using a Hawaii partnership to skirt HARPTA then it may instead require a tightening up of the HARPTA rules. The Chairman pointed out that, if there are offsetting losses, they can always get their money back; this is a withholding provision rather than an additional tax.

Ms. Ching asked if trusts and estates are considered pass-through entities. It was agreed that they were not.

<u>It was moved by Ms. Ching and seconded by Dr. Grandy that Hawaii should adopt withholding rules for all nonresident taxpayers involved in pass-through entities such as partnerships, S-corporations, and limited liability companies. The motion was passed with the following votes: 7-Yes.</u>

The Chairman called for the vote:

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

<u>49. The Department of Taxation should consider focusing on reducing the "Tax Gap."</u>

Dr. Rousslang read the original suggestion 49 from Mr. Charles Rettig. Increased information reporting and increased or expedited information exchanges could significantly reduce the tax gap (i.e., the difference between taxes actually owed and those collected).

The Chairman stated that Mr. Grant Kawamoto of the IRS gave a presentation the past weekend on the tax gap during which he mentioned his neighbor who was building something with cash labor. The Chairman asked if there was more leakage due to that kind of activity or illegal tax shelters.

Mr. Roberts stated that he had related to Mr. Kawamoto, prior to his presentation, an experience he had where he had heard some people at a nearby table take pride in saying that they capped the income they reported at $60,000 and whatever exceeded that they just didn't report. The father, who was visiting from the mainland, was shocked and told them why they should pay their taxes; he could not understand the psychology of why they thought it was a good thing to evade taxes. Mr. Roberts is concerned that a tipping point is being reached where voluntary compliance breaks down because the psychology of the public no longer supports compliance.

The Chairman stated that the suggestion implies that the Department is not focusing on the tax gap, but he thinks they are; it is a fairness issue. Ms. King stated that she sees the same thing, but mostly amongst the wealthy.

Mr. Hirai mentioned that there was a bill pending in the Legislature regarding owner-builders and building permits. Just as was being suggested by Mr. Rettig, owner-builders had to provide an accounting of whom they paid on their building permit. If you had a certain amount on your building permit, you would be required to account for whom you paid it to.

The Chairman noted that many people put a low number on their building permit because the fee is based on how much you spend. Dr. Pham also mentioned that they list a low number because they are afraid of the property tax valuation going up. However, Mr. Hirai stated that this was to get their notice of completion. If you purposefully underreported it, it was a Class C felony, or something like that, for filing a false statement. Dr. Pham stated that the permit office has a duty to check the numbers given when people apply for a building permit and could correct the numbers.

Ms. Nakamura mentioned that the Administration had a bill on abusive tax shelters, preparers, and promoters the last session, but that it didn't go anywhere. She speculated that the small-time cash jobbers might argue that the wealthy can shelter their money by doing fancy things regular folks can't afford, so why shouldn't they hide some of their money too. She feels that if the State could shut down abuses by the wealthy people, then regular people would be more inclined to pay their taxes.

The Chairman stated that he believes that the reason many people work for cash is not to evade taxes, but to avoid workmen's compensation, which is a much bigger figure than taxes.

No further action needs to be taken at this time on this issue, as it is something the Department is addressing. Mr. Roberts stated that they should examine more closely the resources that the Department has to administer State taxes if the opportunity arises, perhaps as part of the tour of the Department for auditors, and other compliance staff.

Ms. Nakamura added that attention should also be paid to front-end areas including technology. The Chairman recognized the need for more computers and systems. Ms. Nakamura stated that you also need the people to go with the increased technology. For example, if the computer system spits out more letters, you must have the staff to answer calls from the letter recipients who have questions.

Mr. Roberts stated that the focus of this issue is to get at those who are skimming off the top of their records rather than those the Department already knows about, and for that the Department needs feet on the ground.

This concludes the discussion on the list of suggestions for statutory and administrative changes received from the public.

LIST AGENDA ITEMS FOR THE NEXT MEETING

Before adjourning, Dr. Grandy stated that he had communicated with Dr. William Fox, the details of which had been circulated to the subcommittee that also consisted of Mr. Heller and Ms. Ching. One of the issues that Dr. Fox raised was whether the Commission wanted him to present his findings in person so that he could answer questions. There is a $1,500 line item for travel costs in Dr. Fox's proposal. The Chairman said that it would be fine since $1,500 is allocated for him to use for travel.

Mr. Roberts asked if having a telephone conference instead would raise public access issues. Ms. Ching stated that doing so won't save any money since it is in the budget for that purpose. Ms. Erickson said that the Sunshine Law does not contemplate telephone conferences.

Dr. Pham asked if the public must have access to where he gives the speech in Tennessee.

The Chairman said that he should come if it is within the budget. Mr. Heller asked when he should come. The Chairman said that he would prefer that it be after they receive his preliminary report. Dr. Grandy agreed; Dr. Fox can receive their questions and comments and then finalize the report. August is not good because they already have Streamlined Sales Tax on the agenda with various guests in attendance. Perhaps a separate meeting would be best. Dr. Pham stated that perhaps Marcia Sakai could come at the same time. The Chairman agreed that a separate meeting would be best. Dr. Grandy will work with the subcommittee to arrange it.

The Chairman stated that he and Dr. Rousslang would set the agenda items for the next meeting. He thanked the members for agreeing to the extended meetings as they have been able to accomplish a lot.

The Chairman also reminded the Commission of all the things he's compiling for eventual inclusion in the report, and that they are welcome to look at it.

Ms. Ching asked when they will be going on the office tour. Dr. Pham said that they could have it whenever they want.

The next Tax Review Commission meeting will be on July 25, 2006, at 9:00 a.m.

ADJOURNMENT

It was moved by Mr. Heller and seconded by Ms. King to adjourn the meeting at 11:20 a.m. The motion was carried unanimously.