

TAX REVIEW COMMISSION

**MINUTES OF THE ELEVENTH MEETING OF THE
TAX REVIEW COMMISSION
HELD AT 830 PUNCHBOWL STREET
DEPARTMENT OF LABOR & INDUSTRIAL RELATIONS ROOMS 310-313
IN THE CITY & COUNTY OF HONOLULU
STATE OF HAWAII, ON TUESDAY, JULY 24, 2012 AT 9:00 A.M.**

The members of the Tax Review Commission (TRC) met at the Department of Labor & Industrial Relations Conference Rooms, in the City and County of Honolulu, State of Hawaii, on Tuesday, July 24, 2012.

Members Present: Randall Y. Iwase, Chair
Mitchell A. Imanaka, Vice-Chair
Roy K. Amemiya, Jr.
Michael T. McEnerney
Darryl K. Nitta
Peter S. Ho

Staff: Donald Rousslang Titin Sakata and Sondra Kaawa

Others: Randall Nishiyama, Department of the Attorney General
Hamid Jahanmir, Department of Taxation
Lowell Kalapa, Tax Foundation of Hawaii
Ken Takenaka, GCA
Marcie Kagawa, Hawaii Business Magazine
Nandana Kalupahana, House Finance
Jana Moore, Hawaii Interpreting Services

CALL TO ORDER

TRC Chair Iwase called the meeting to order at 9:00 a.m.

APPROVE MINUTES FROM PREVIOUS MEETING

Chair Iwase said the first order of business on the agenda was the approval of minutes for the meeting of June 21, 2012. He asked if there were any changes, comments or requests for amendments to the minutes.

Chair Iwase asked for a motion to approve the minutes for the June 21, 2012 meeting. The motion was made by Mr. Amemiya and seconded by Mr. Nitta. The motion carried unanimously.

COMMUNICATION TO THE COMMISSION

Chair Iwase asked Ms. Sakata if there were any communications to the TRC.

Ms. Sakata said that the Public Financial Management Group (PFM) sent in their progress report. She said they have obtained the requested additional expenditure data from the Department of Budget and Finance. She said that PFM planned to submit the draft of their report on August 27, 2012, and they proposed to present their model to the TRC on August 29th, August 30th, or August 31st.

Chair Iwase said the TRC will discuss PFM's proposed dates at the end of the agenda. He noted that August 29, 2012 would probably be the date for the next TRC meeting. He asked that if any of the commissioners have a conflict, they resolve it in favor of attending the next TRC meeting.

Chair Iwase asked Ms. Sakata if there were any other communication to the TRC.

Ms. Sakata said no.

Mr. Amemiya asked if the PFM representatives were able to speak with Dr. Paul Brewbaker.

Ms. Sakata said no.

UPDATE OF STUDIES BY DR. WILLIAM FOX

Chair Iwase said the next item on the agenda is the update of the studies by Dr. William Fox. He said Dr. Fox is not able to present his study in person, so Dr. Rousslang will present a summary of the report. Chair Iwase suggested that commissioners raise questions about the report at the end of Dr. Rousslang's presentation, so that they can be transmitted to Dr. Fox.

Dr. Rousslang presented the following:

Dr. Fox does three things. He provides an estimate of the losses of revenue from ecommerce and catalog sales, examines several GET exemptions, looks at what other states have been doing to combat losses from ecommerce and gives some estimates for the increases in GET that would be necessary to replace various income tax reductions, such as the elimination of the individual income tax or elimination of corporate income tax.

Dr. Fox points out that Hawaii's GET is very broad compared to sales taxes of other states. In Hawaii, it accounts for over half of our total tax revenue whereas the overall average for all other states is less than one third. Hawaii's Get base is 100.7% of total personal income, whereas for other states the sales tax base is only about a third of total personal income.

To estimate the losses from ecommerce, Dr. Fox uses several data sources. The data on ecommerce is available only at the national level. He imputes ecommerce data by state based on the national level of ecommerce. The data on national ecommerce are broken down by type of sale, whether it's a sale by a manufacturer, a wholesaler, a provider of services or a retailer. He also has data for the nation as a whole on the types of customers for each type of seller, such as sales of manufacturing to business or sales of manufacturing to a wholesaler or sales of manufacturing to a final consumer.

Estimates of compliance rates for taxes on ecommerce are also at the national level and Dr. Fox got these rates by examining websites of about one hundred large ecommerce sellers. The overall average was that they paid sales tax on 20% of their sales. If the ecommerce business sells to a final consumer and they don't pay the sales tax, then it's the consumer's responsibility to pay use tax and they almost never do. If you don't get the tax from the company, you won't get it. For businesses, however, it's much different. Even if the ecommerce seller doesn't collect tax, the business is likely to pay Use Tax. To get the compliance for businesses, he used a study by Washington State Department of Revenue, which found that businesses paid about 70% of the Use tax on their purchases from ecommerce even if the sellers did not collect the tax.

Dr. Rousslang said Dr. Fox's first step was to forecast total ecommerce sales. Because the national data ended in 2009, he had to forecast the ecommerce sales through 2015. He did this by applying rates of growth in ecommerce relative to GDP. For the forecasts of GDP, he used Global Insights. Growth in catalog sales is projected to be much less than growth of ecommerce. His estimates of this growth are based on historic rates of growth of non-store retailers.

The next step is to estimate the ecommerce sales to Hawaii customers. Dr. Fox does this by taking the national ecommerce sales and allocating shares to each state equal to the state's share of total state and local sales taxes in the nation. By this method, Hawaii gets about 0.8%, even though Hawaii's economy is roughly only about 0.5% of the overall national economy.

Next, Dr. Fox estimates the GET and Use tax due on ecommerce sales. The tax due depends on the type of sale and the type of customer. For example, sales to final consumers are subject to 4%, sales to wholesalers or sales to Hawaii importers who resell at wholesaler are exempt from Use tax, sales to Hawaii importers who sell to retailers are subject to tax at .5%. Dr. Fox uses data on the type of seller and type of customer to estimate the total GET or Use tax due on ecommerce.

The step after that is to estimate how much of the tax due is actually paid. This is done by applying the compliance rate to the various types of sales.

The results are summarized in Table 1. In 2012, Dr. Fox estimates the total tax due on ecommerce was \$297 million and the tax due on mail order was \$39 million, for a total of \$336 million in tax due on remote sales. He estimates that only \$191 million was actually collected, which leaves a revenue loss of \$145 million, of which about \$114 was due to ecommerce sales and \$31 million was due to catalog sales.

Next, Dr. Fox summarized federal legislation on remote sales. The Main Street Fairness Act requires states to comply with certain simplification and harmonization rules before seller's collection is required. The Act determines that the required simplification and harmonization have occurred when states have become full members of the Streamlined Sales & Use Tax Agreement.

The Marketplace Equity Act develops a unique set of criteria that must be met before states can require remote firms to collect the sales tax. The criteria have some similarities to the SSUTA but are not exactly the same. Among the criteria are the requirement the states must allow a small seller exception, they must have a remote seller tax return and a single tax authority for remote sellers, they must have a single set of definitions for taxable items across the state, they must impose either a blended state and local tax rate, they must have a maximum state rate or applicable destination tax rate for each local jurisdiction, and they must publish detailed information about collection requirements about six months in advance.

The Marketplace Fairness Act mixes the approached of the other two bills.

Dr. Fox thinks none of the efforts by other states to collect sales tax on remote sales has been very effective. The main approach has been to broaden the definition of nexus to include ownership of a related company in a state or when an internet sale is made through a company with local presence (the so-called click-through nexus). A second approach has been to require information reporting by remote sellers.

The next part of Dr. Fox's study is an Assessment of Revenue Costs of Various GET exemptions. He breaks the exemptions down into two types: exemptions for consumers and exemptions for business inputs. The first category includes exemptions for nonprofit organizations, for sales of prescription drugs, and for health insurance premiums paid to HMO's and mutual benefit societies. The second category includes exemptions for amounts received by hotel operators as reimbursement for employee wages, for rents from aircraft leasing, for aircraft maintenance and repairs, and for payments to subcontractors.

The main reason for breaking the exemptions into two categories is that the second category can basically be viewed as anti-pyramid relief from the GET. Dr. fox gives an assessment of revenue gain that would be obtained from eliminating each one of the

various GET exemptions that he examined. He estimates a revenue gain of \$254 million from eliminating the exemption for nonprofit organizations. To put this in perspective, he says it is 5.2% of the total GET collections. The exemption for health insurance premiums is estimated to cost \$108 million, the subcontractors' deduction costs \$96 million, the exemption for hotel wages costs \$46 million, the exemption for prescription drugs costs \$30 million, the exemption for aircraft leasing costs \$4 million and the exemption for aircraft maintenance costs \$2 million. The total is \$540 million for all of these exemptions.

Dr. Fox points out that the estimates for the cost of the subcontractors' deductions and hotel wages overstate the true revenue losses owing to behavioral responses.

The last part of Dr. Fox's study goes through consequences of replacing the revenue from the corporate and personal income taxes with an increase in GET. The results are summarized in Table 3. He found that if we eliminated corporate and personal income taxes, we would have to raise the GET to 6.1% to replace the lost revenue if there were no behavioral responses at all and the economy and tax base stayed the same. Of course, there might be behavioral responses: there might be more investment; workers might work more because their after tax wage would go up; and people might shift to untaxed goods and services in response to the increase in GET. More investment and work effort would expand the economy and thus GET receipts, but people shifting away from taxable items reduces them. The net effect of those two forces is that we would have to raise the GET to 6.2% after behavioral responses if we eliminate corporate and individual income taxes. If we eliminate corporate tax only, we would have to raise the GET to 4.1%, and it's the same after behavioral responses. If we eliminate the individual income tax, we would have to raise GET to 6% if there were no behavioral responses and to 6.1% to account for the behavioral responses. If we eliminate the individual income tax for those below the poverty line, we would have to raise GET to 4.2% to make up the lost revenue. The estimate is the same with or without behavioral responses. If we eliminate the income tax for the bottom 90% of taxpayers, we would have to raise GET to 5% to make up the revenue loss if there were no behavioral responses and to 5.1% after accounting for the behavioral responses.

Chair Iwase thanked Dr. Rousslang for his presentation and asked if there were any questions regarding Dr. Fox's study.

Mr. Ho asked for the following information: (1) the income threshold for the bottom 90% as stated in Dr. Fox's report, and (2) the necessary GET rate if Hawaii had the same tax bases as the other states, or the necessary sales tax rate for other states if they had Hawaii's tax base, to generate the same tax revenue.

Dr. Rousslang asked if Mr. Ho was asking for the GET as a fraction of total income, or for GET paid per capita compared to the sales tax paid per capita in other states.

Mr. Ho said if we were to hold one variable constant, for example, the breadth of the tax, what the tax rate would be for other states if they had Hawaii's tax base.

Mr. McEnerney said if we use Hawaii's base, for example, to generate the same tax revenue for Illinois using Hawaii's base, Illinois tax rate would be lower because their current base is narrow. He said it is not fair to compare Hawaii's rate of 4% to Illinois' rate of 9% because Illinois' base is much smaller than Hawaii's base.

Mr. Ho said Mr. McEnerney explained succinctly what he was asking.

Dr. Rousslang said he thought Mr. Ho's question could be addressed by looking at taxes per capita or as a percentage of personal income.

Chair Iwase said the TRC is asking Dr. Fox to make an apples-to-apples comparison. He said the TRC's question to Dr. Fox is if, for example, California has a broad base like Hawaii, what will California's sales tax rate be?

Mr. Ho said he thinks it's very dangerous to analyze policy without having an effective measure.

Mr. McEnerney asked if the Department of Taxation or Dr. Fox considered using the net income tax return, such as Form N-11, to add a provision that says "have you purchased goods or services from interstate commerce during the past year in an amount exceeding "X" thousand dollars, and if so then you owe the state the use tax of 4% times the amount of purchases." Mr. McEnerney thought it would be logical to assume that people with higher income are more likely to engage in interstate commerce than people with lower income. He said by tying the income to estimated interstate commerce could be a simple collection method that several other states have used.

Ms. Sakata said the Department has considered that option. She said that there are challenges in implementing the option, such as having income and use taxes, which are two separate taxes, on one tax form. She said this cannot be done simply.

Mr. McEnerney said the Department should remember that the average individual is going to have difficult time complying with the use tax statute that requires getting a license and filing a use tax form.

Mr. Imanaka asked that Dr. Fox provides more information in his report that indicates when there is a shift away from a consumption tax, it will increase economic output.

Chair Iwase thanked Dr. Rousslang and asked that the questions posed by the TRC be transmitted to Dr. Fox and be provided to the TRC by the next meeting.

Chair Iwase asked the TRC to look at PFM's progress report, page 5, which notes their draft report is due on August 27, 2012. He said PFM will be here on August 29th, 30th or 31st to

present live demo of their model. He proposed a meeting on Wednesday, August 29, 2012, at 9:00 a.m.

Chair Iwase said the TRC will probably be meeting more frequently. He said with the completion of Dr. Fox's report and the anticipated receipt of PFM's report on August 27, 2012, he would suggest a public hearing at the State Capitol auditorium to get public input on both reports.

Chair Iwase said the TRC has retained Dr. John Knox as a staff researcher and writer. He said Dr. Knox will be responsible for drafting the TRC's report. He proposed having a meeting in October to vote on the TRC's recommendations. He said the TRC could discuss their recommendations again in November. He said the TRC's report is due in December.

Mr. Amemiya said the Department will also do reports for the TRC.

Chair Iwase asked that the Department provide the reports on the "Eliminating the Income Tax for Those Below Poverty Level", "Tax Adequacy Study", and Collection Process on August 29, 2012.

NEXT MEETING

Chair Iwase set the next meeting on Wednesday, August 29, 2012 at 9:00 a.m.

ADJOURNMENT

The meeting was adjourned at 9:44 a.m.