MEMORANDUM

TO: Hawaii Tax Review Commission

FROM: Winston I. Wong

DATE: September 15, 2021

RE: Credits and Exemptions

I. SUMMARY

This memorandum discusses four proposed actions by the 2020-2022 Hawaii State Tax Review Commission (the "**Commission**") involving tax credits and exemptions in the State of Hawaii. Hawaii's tax credits and exemptions often reflect policy objectives of the State and the equity and efficiency of these tax credits and exemptions are within the scope of the Commission's review of the State's tax structure as defined under Hawaii Revised Statutes ("**HRS**") Section 232E-3. After a review of past commissions' reports and data from the Department of Tax and State Auditor, I recommend the following:

a. *The Commission should evaluate the efficacy of exemptions identified in existing State Auditor's reports*

b. *The Commission should evaluate the definition of "Cost" for the Capital Goods Excise Tax Credit*

c. *The Commission should evaluate the expected revenue costs of the State's exemption of pensions and Social Security Benefits*

d. *The Commission's should determine if a general compilation of revenue costs for General Excise Tax credits and exemptions for 2018 through 2020 can be included in the Commission's Final report*

II. BACKGROUND

A tax exemption excludes certain income, revenue, or taxpayers from a tax. Similar to deductions, exemptions decrease a taxpayer's taxable income. Tax credits, on the other hand, decrease a taxpayer's tax liability. Because tax credits are applied on a dollar-for-dollar basis to the actual amount owed, they are more valuable to taxpayers than ordinary deductions or exemptions. Numerous tax exemptions and credits have been enacted for the Hawaii State income tax and GET, with most of them being designed to promote social welfare, encourage certain industries or economic activities, and avoid double taxation or the pyramiding of taxes.[1]

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[1] Tax Credits Claimed by Hawaii Taxpayers, Tax Year 2018 (January 1, 2018 – December 31, 2018), Department of Taxation, State of Hawaii, at p. 9 Figure 4 (Sept. 2020).

One criticism of credits and exemptions is that they are inherently tailored to benefit specific parts of the population more than others. While this generally goes against the standards of equity that tax systems aim for, the public often is willing to accept the unequal treatment of taxpayers if the credits/exemptions further a social purpose or stimulate desirable economic activity.

Another criticism of credits and exemptions is that they complicate the tax system and require taxpayers to expend more effort and resources in order to obtain their benefit. The 2005-2007 Tax Review Commission chaired by current State Director of Tax, Isaac Choy, recommended that the state minimize all tax exemptions and credits in an effort to simplify the tax system.[2]

III. PROPOSED ACTIONS FOR THE COMMISSION

a. <u>The Commission Should Evaluate the Efficacy of Exemptions Named in Existing State Auditor's Reports</u>

In 2016, Senate Concurrent Resolution ("**SCR**") 58 asked the 2015-2017 Tax Review Commission "to conduct or commission a study evaluating all or certain state income tax credits, exclusions, and deductions[.]" However, the 2015-2017 Commission decided against an evaluation of exemptions primarily because of a lack of reliable data on the amount of the exemptions being claimed and because Act 177, Session Laws of Hawaii ("**SLH**") 2017 already requires the State Auditor to conduct an extensive review of the costs and benefits of the GET exemptions, as well as other exemptions, exclusions, tax credits and deductions provided under Hawaii's tax laws.

It is unlikely that the Commission can execute a full review of all the State's tax credits/exemptions due to the complexity of the system and sheer number of statutes in place. However, the Commission can still efficiently offer its insight on various GET exemptions highlighted by two reports issued by the State Auditor in the past year. These exemptions were identified as requiring either clarification or reevaluation because they no longer appear to achieve their intended objectives. The current Commission would be well served to use the State Auditor's reports as a starting point for the evaluation of specific credits and exemptions because much of the analysis has already been done. Therefore, I recommend that the Commission evaluate the following credits/exemption statutes in the State Auditor's reports that were identified as requiring revision or scrutiny by the legislature:

Review of General Excise and Use Tax Exemptions and Exclusions Report No. 20-09 (June 2020), http://files.hawaii.gov/auditor/Reports/2020/20-09.pdf

- HRS 237-3(b) - Clarification of exclusions under definitions of "gross income" and "gross proceeds of sale" (pp. 43-44)

[2] *See* State of Hawaii Tax Review Commission (2005-07), Report of the 2005-2007 Tax Review Commission, at p. 13 (Dec. 1, 2006).

- HRS 237-24.3(11) **–** Evaluation of exemptions to support interisland air carriers (pp. 17-20)

- HRS 237-24.5 **–** Evaluation of exemption for amounts received by securities exchanges or exchange members (pp. 25-27)

Review of General Excise and Use Tax Exemptions and Exclusions Pursuant to Section 23-73, Hawaii Revised Statutes, Report No. 21-07 (April 2021), http://files.hawaii.gov/auditor/Reports/2021/21-07.pdf

- HRS 237-24(13) **–** Evaluation of $2,000 exemption of amounts received by blind, deaf, or totally disabled persons from their business (pp. 25-27)
    - When read in conjunction with HRS § 237-17, which limits GET assessed on business or other activities of individuals who are blind, deaf, or totally disabled to 0.5 percent, the exemption is worth only $10.

- HRS 237-24 **–** Evaluation of exemption of amounts received by independent cane farmers who are sugarcane producers (pp. 28-30)

b. <u>The Commission Should Evaluate the Definition of "Cost" for the Capital Goods Excise Tax Credit</u>

The Commission should also bring attention to a lack of clarity in the Capital Goods Excise Tax Credit ("**CGETC**"), an income tax credit aimed at avoiding double taxation or "pyramiding",[3] which grants a credit to taxpayers for purchases of "eligible depreciable tangible personal property used in a trade or business and placed in service within Hawaii after December 31, 2009." HRS § 235-110.7(a). The amount of the credit is "four per cent of the cost of the eligible depreciable tangible personal property." HRS § 235-110.7(a). The current definition of "cost" gives taxpayers two choices for determining the cost of the tangible personal property:

(1) Actual invoice price of the tangible personal property; or

(2) Basis from which depreciation is taken under section 167 (with respect to depreciation) or from which a deduction may be taken under section 168 (with respect to accelerated cost recovery system) of the Internal Revenue Code of 1954, as amended, whichever is less.

HRS 235-110.7(f). However, the "whichever is less" phrase at the end of HRS 235-110.7(f) precludes taxpayers from ever using the depreciable basis (including labor costs of installation and delivery) as the cost of that tangible personal property for the CGETC.

[3] Tax Credits Claimed by Hawaii Taxpayers, Tax Year 2018 (January 1, 2018 – December 31, 2018), Department of Taxation, State of Hawaii, at p. 24 (Sept. 2020).

c. <u>The Commission Should Evaluate the Expected Revenue Costs of the State's Exemption of Pensions and Social Security Benefits</u>

The most notable income tax exemptions are for pension and Social Security income under HRS § 235-7, which constitute the largest source of untaxed income for the State ($5,729 million claimed).[4] Prior commissions have regularly identified the State's pension exemptions as a concern and, with the exception of the 2010-2012 Commission, all advocated for the State to gradually adopt rules in conformity with the federal treatment of retirement income.

These recommendations generally agreed that the current treatment is not "even-handed" because it distinguishes unfairly between different types of retirement income, and because of budgetary concerns brought on by the general aging of the U.S. population.[5] Both of these concerns remain relevant for the State in 2021, but have not been studied in-depth since Professor Andrew Mason of the University of Hawaii prepared a report for the 2001-2003 Commission entitled "Aging, Pension Income, and Taxes in Hawaii".

Although amounts claimed under this exemption were expected to somewhat diminish over the next 75 years as 401(k) plans replaced pensions, Hawaii still exempts nearly 16% of all individual income through its pension and Social Security disbursements, which is greater than all individual income from capital gains, self-employment income, and interest and dividends.[6] The Commission should follow up on this prediction and determine whether pension and Social Security exemptions have decreased since the 2001-2003 Commission's Report and are sustainable for the future.

d. <u>The Commission's Should Determine If a General Compilation of Revenue Costs For General Excise Tax Credits and Exemptions For 2018 Through 2020 Can Be Included In The Commission's Report</u>

SCR 58 noted that the 2005-2007 Commission's review of exemptions and deductions was "immensely helpful to subsequent legislatures," and current legislators have indicated that a continuing desire that a summary of the State's credits and exemptions be included by the Commission in its report. The Department of Taxation recently completed studies of credits and exemptions in September and December of 2020 and has made much of this information available on its Tax Data Portal. However, the Department's report on credits only shows credits claimed in 2018, while the report on exemptions shows data from 2019.

Succinct summaries of the most recent credit and exemption data for the last 3 years (2018-2020) would be useful to the Commission's analysis if they are available and can be

[4] *See* Colby, Seth, *Hawaii Tax System: Income Tax – Tax Review Commission*, Tax Research & Planning, DOTAX, at p. 28 (Jan. 20, 2021).

[5] State of Hawaii Tax Review Commission (2001-03), Report of the 2001-2003 Tax Review Commission, at p. 16 (2003).

[6] *See* Colby, Seth, *Hawaii Tax System: Income Tax – Tax Review Commission*, Tax Research & Planning, DOTAX, at p. 20 (Jan. 20, 2021).

included in the Commission’s report. Given the recent modernization of the State’s tax systems and the existing availability of much of this data, the Commission should consult whether the Department of Tax would be able to efficiently compile a summary of credit and exemption data for the past 3 years (2018 and 2020) for inclusion in the Commission’s final report.