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September 30, 2017

Ms. Colleen M. Takamura, Chair
Tax Review Commission
c/o Rules Office, Department of Taxation
830 Punchbowl Street, Room 219
Honolulu, HI 96813

Re: **Comments on "Study of the Hawaii Tax System," Draft of Aug. 7, 2017, by PFM Group Consulting LLC (the "Draft Report")**

Ladies and Gentlemen:

Thank you for the opportunity to provide comments to the Commission on the study that it is undertaking on the State's tax structure as provided for in Article VII, section 3 of the Constitution of the State of Hawaii.

A. Scope of the Study.

The Draft Report recites that the Commission has decided to focus on three specific areas of tax policy, namely:

- Who bears the burden of Hawaii's taxes (including how much is exported to visitors)?
- What are the most effective ways to reform Hawaii's taxes to make them less regressive?
- What are the best ways to generate more revenue through new and existing sources, and through improved compliance with Hawaii's tax laws?

Of the three areas, we must express our concern about the third. As we testified before the Commission in 2012, we believe that consideration of revenue adequacy, which PFM Group has identified as a necessary component of this area, is beyond the scope of the Commission's mandate as expressed in the Hawaii Constitution and in HRS chapter 232E. Budgeting decisions are the province of the Hawaii Legislature, which takes the fiscal requests of the Executive and Judiciary branches of government and aligns them with available resources as forecasted by the Council on Revenues.

It is not the purpose of the Commission to give lawmakers a convenient menu of tax increases that they can order, like large fries and a Coke, when those lawmakers don't want to make tough decisions about how to right-size our state government and otherwise making it live within its means.

B. Tax Structure Recommendations.

1. Methods to Expand the Tax Base.

a) Reduce the Pension Exemption in the Individual Income Tax.

This recommendation deserves serious consideration as the defined benefit pension plans to which this exemption primarily applies are going the way of the dinosaur. Proposals to reduce or eliminate the income tax exemption for defined benefit pension payouts were made every so often, including by the previous administration, and were met with substantial resistance.

The current structure of this exemption is problematic because it applies without limit and without regard to where the taxpayer was when he or she was earning the pension. It's possible that the exemption was designed to make it easier for those who have toiled long and hard in other places to come to Hawaii to retire and to use their retirement money to help our local economy. That, however, must be weighed against our other substantial fiscal needs and priorities to see if the justification is still viable.

b) Eliminate the Deduction for Property Taxes Paid.

For several decades it has been the policy of the state to maintain conformity between state law and the federal Code to minimize the differences between the two allowing for ease of compliance and administration of the net income tax law. Eliminating the deduction of the real property tax will create yet another difference between the two laws and runs counter to the state's policy to conform to the federal Code.

c) Tax Medical Marijuana.

Act 306, SLH 1986, provided that sales of prescription drugs and prosthetic devices are exempt from the Hawaii general excise tax. This exemption, codified at HRS section 237-24.3(6), provides an exemption from the GET for those amounts received by a hospital, infirmary medical clinic, health care facility, pharmacy, or a practitioner licensed to administer the drug to an individual for selling prescription drugs or prosthetic devices to an individual. This exemption does not apply to any amounts received for services provided in selling prescription drugs or prosthetic devices.

A study prepared for the 2005-2007 Tax Review Commission examined the need for this exemption:

> Hawaii and all other sales taxing states except Illinois exempt prescription drugs from the sales tax. Illinois levies a 1 percent rate on the sales of prescription drugs. A comprehensive list is not available of sales tax treatment for prosthetic devices, but they are likely exempt in essentially every state as well. Hawaii could choose to eliminate exemptions for these transactions, in keeping with the generally broad tax base imposed in the state. Expanding the base to drugs and prosthetics would allow additional revenue or a lower tax rate. The potential tax base from drugs and prosthetics is estimated to be at least $845 billion in 2006, which

> would generate $33.8 million if fully taxable. Taxation of these transactions would allow the GET rate to be reduced to 3.94 percent and still raise the same revenue.
>
> As with other exemptions, taxation would eliminate the incentive to purchase these goods rather than other currently taxed items. However, the distortion in consumption is probably very small because people are likely to buy nearly the same quantities of drugs and prosthetic devices even with reasonable levels of taxation because of the limited degree of substitutes and the view that many of these are necessities. On the other hand, there are opportunities to purchase some drugs remotely, and taxation could encourage some additional remote purchases.
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> The argument for exemption lies mainly in equity, with many people believing that it is unfair to sales tax necessities such as drugs and prosthetics. The perception is that a tax on drugs and prosthetics is a tax on suffering. Of course, some other necessities, such as food, are sales taxed in Hawaii and in many states, and all prescriptions may not be viewed as necessities depending on one's perception. Thus, the case for exemption presumes that drugs and prosthetics devices are more worthy of exemption than many other possible candidates.

Fox, William, "Hawaii's General Excise Tax: Should the Base Be Changed?" (2006) (footnotes omitted) (Appendix C to the Report of the 2005-2007 Hawaii Tax Review Commission, available at http://files.hawaii.gov/tax/stats/trc/docs2007/Final_Report-Appendix_C.pdf).

The underlying policy behind the exemption supports application to medical marijuana. After all, it is prescribed by a health care professional to treat disease. If it is decided that the exemption should be denied, as it is under current law, policymakers need to ask why medical marijuana needs to be treated differently from all other prescription drugs, including such substances as Viagra and Cialis. The Draft Report's proposal to expose medical marijuana to an enhanced tax rate makes this policy problem worse.

These comments, of course, do not apply to marijuana for recreational use, which is heavily taxed in those states that have legalized it to that extent.

d) Institute a Vapor/e-Cigarette Tax.

Care should be exercised in attempting to generate additional revenues from specific excise taxes like the tobacco tax. First, the tobacco tax is designed to deter consumption by making it more expensive. If this works, consumption will drop and the revenue generated will be less, not more. Next, Hawaii's tax rates on these products are already among the highest in the nation. Not only would another rate increase reaffirm the perception that Hawaii is a tax hell, but it would probably drive consumers to find other sources for these products that would not incur the tax. Mail order and internet sales are sources of product that could escape taxation as well as black market purchases made from the military reservations in Hawaii. So instead of seeing growing collections from higher tax rates, lawmakers may just find that collections will drop due to its effect to discourage consumption and send consumers to other markets. As noted above, the higher one pushes the cost of these products, the greater the possibility of seeing a decline in consumption as consumers quit, moderate consumption, or shift it in ways that would avoid the tax. In fact, as was evidenced in the states of

New Jersey and Maryland, lawmakers there counted on an increase in the cigarette tax to help balance their budgets only to learn that collections went down below their prior levels.

Hikes in the tobacco tax have begun to affect collections not only locally but also nationally. Collections have fallen below their previous levels. For whatever reason, the rise in rate has jeopardized this source of revenue. If nothing else, lawmakers need to make up their minds whether they see this tax as a source of revenue or a means by which to deter consumption.

2. Methods to Reduce Regressivity in Certain Taxes.

a) Increase the Standard Deduction for IIT [Individual Income Tax] to $7,500 for single filers, $15,000 for married and $10,950 for head of household filers.

This recommendation deserves serious consideration. Hawaii has for years taxed families whose income was at or below the poverty line as income tax rates and brackets were not adjusted for more than 20 years after they were first increased after Hawaii became a state. However, that first adjustment came not because inflation had spurred the income of families in Hawaii beyond the income brackets that had been adopted in 1965 as much as it was the change in the income tax base brought about by the 1986 Federal Tax Reform Act which broadened the income tax base. Even then the rates and brackets were never fully adjusted for the base broadening, as policymakers at the time were unsure of the revenue impact adjustments to the rates would have on the state treasury. Instead, the first permutation of the food tax credit was adopted to offset the increase in income taxes brought about by the base broadening.

b) Double the refundable Food/Excise Tax IIT credit.

While doubling the food tax credit would indeed offset the regressivity of the general excise tax for the poor, consideration should be given to a more progressive adjustment of the low and middle-income tax brackets to provide relief across the board.

In addition, the Commission should consider that it is much more complicated and expensive to deliver relief by way of a refundable credit than by just reducing the tax, or, even better, raising the tax threshold levels so people at the lower end of the income spectrum are not burdened with having to file income tax returns.

- Taxpayers who qualify for this credit need to claim it by filing a tax return. A tax return is a complex document, very expensive to process and very burdensome for a taxpayer. Taxpayers at this income level who are assisted by paid preparers or refund anticipation loan providers sometimes end up paying substantial fees to such professionals instead of having all of the tax credit dollars going toward sustenance of the taxpayer and family.

- The credit in its current form is refundable, meaning that a taxpayer with no liability will get a check from the State for a credit amount. Checks, in our current system, go through two agencies (DOTAX and DAGS) before being issued. This adds to the complexity and administrative cost to State government. Then, there are issues surrounding how to deliver a check to a taxpayer without a permanent address.

- Most of the Hawaii income tax credits, including this one, are forfeited if not claimed within a year after the taxable year end. In addition, the current tax structure begins imposing tax at an ungodly low amount, such that a taxpayer at the poverty line is already in the fourth tax bracket from the bottom. Taxpayers who for whatever reason do not file timely returns thus may end up owing state tax even though far below the poverty line.

For these reasons, the Commission should consider ways to keep those at or below the poverty line off the tax system rather than trying to force them to comply with complex laws and regulations.

3. Methods to Export a Share of the Tax Burden to Non-residents.

a) Increase cigarette and tobacco tax rates.

The Draft Report argues that an increase in these taxes will shift the burden to visitors to Hawaii and, therefore, export the tax burden to nonvoting consumers. At the same time, the Draft Report also acknowledged that Hawaii already has among the highest tax rates on these products. As a result, there should be concern about how such high rates contribute to a decline in consumption and, therefore, tax collections. We note that the collection of cigarette taxes appears to be declining over time. Please also see section 1.d) above (regarding taxation of e-cigarettes under the tobacco tax) for further background.

b) Increase gallonage taxes on beer, wine and distilled spirits.

With respect to alcoholic products, again, Hawaii has among the highest rates in the nation. While it may be assumed that visitors will purchase alcoholic beverages while on vacation, what concerns us is the on-premise consumption if the cost of that beverage rises. We have learned anecdotally that visitors who stay in time shares and condominiums have learned to purchase their alcoholic beverages in quantity at outlet stores, consume what they will during their stay here in Hawaii and return any unopened product when they leave.

This erodes sales of alcoholic beverages served on premise which tend to carry a higher margin that is used to offset losses incurred on food served. Should this happen, it will, no doubt, affect the hospitality industry, including employment in it and the business itself. It may not stop purchases on-premise altogether, but it will, no doubt, affect the volume of sales.

c) Increase the TAT and TOT Rates.

Unlike many other states, Hawaii imposes the general excise tax in addition to the TAT on transient accommodation rentals. The recently signed rail bailout act adds yet another increase to the TAT, bringing it to 10.25% through 2030. In an apples-to-apples comparison, the tax on hotel rentals approximates 14.25% statewide and nearly 15% in Honolulu, which would probably make Hawaii second highest in the nation in an ad valorem tax on lodging accommodations. It should also be remembered that Hawaii has the second highest room rates in the nation behind only New York which is not considered a leisure destination as is Hawaii. Finally, it should be remembered that the TAT was originally adopted to finance the state's convention center and later when the rate was increased, the money was earmarked for visitor promotion and to assist the counties in maintaining visitor-related infrastructure such as parks and beaches. The debate still rages on between the state and the counties as to how much the latter will be getting out of the TAT pie.

d) Restore the surcharge on rental cars.

This section deals with surcharges on rental cars. State laws provide for several of them. There is a state tax called the Rental Motor Vehicle and Tour Vehicle Surcharge Tax, or RVST. It is imposed at the rate of $3 per day for daily rentals (HRS section 251-2) or 25 cents per half hour or fraction thereof for a car-sharing vehicle (HRS section 251-2.5). To this must be added a separate rental motor vehicle customer facility charge of $4.50 a day (HRS section 261-7(h)) and an airport concession fee of 11.11% for vehicles picked up or returned at a state airport.

One car rental company published an example of a rental vehicle with a base rate of $117.00 per week and calculated that the mandatory Hawaii car rental fees would be another $73.91 per week, for a total of $190.91, under current law.

The recently enacted Act 137, Session Laws of Hawaii 2017, allows car rental companies to list separately other governmental charges, including fees connected with the registration of specially constructed, reconstructed, or rebuilt vehicles, special interest vehicles, or imported vehicles as referenced in section 286-41(c); license plate and emblem fees under section 249-7(b); inspection fees as referenced in section 286-26; highway beautification fees as referenced in section 286-51(b)(1); and any use tax under chapter 238, Hawaii Revised Statutes. Thus, there will be an even greater disparity between the published rental rate for vehicles and the price that the renters will have to pay. During consideration of this bill in the 2017 legislative session, the State Office of Consumer Protection expressed concern that this disparity "will be unfair to certain consumers by creating a state of affairs in which they may be charged an excessive amount for fees and taxes." Raising the taxes on rental vehicles will make this problem worse, not better.

Finally, a note about "exporting" Hawaii's tax burden via the visitor industry. Placing a greater dependence on the fortunes of one industry which has been described as "fragile," places the future of state finances in jeopardy and undermines the stability of the public finance picture in Hawaii. The state's substantial reliance on the general excise tax already underscores the impact of the visitor industry on those collections. To shift even more reliance on the fortunes of the visitor industry creates even more volatility in tax collections.

4. Methods to Improve Economic Efficiency.

a) Institute a Tax on Sugary Beverages.

This suggestion proposes a fee on sugar-sweetened beverages sold in the state. Proponents of a fee on sugary drinks declare that such a fee would act as a disincentive to excessive consumption of such beverages. The problem with that argument is that it penalizes those who may consume such beverages in moderation.

The fee on sugar-sweetened beverages proposed in this suggestion should be viewed as a discriminatory fee increase on such beverages. Economics more often than not dictates what families consume. For example, fresh vegetables and fresh fruit that contribute to a healthier diet are sometimes beyond the means of the poor so they tend to consume large quantities of carbohydrates because they are cheap and filling, but not particularly healthy. If the intent is to promote healthier eating patterns, then that goal can be achieved only with education and understanding on the part of families to replace unhealthy choices with healthy choices. This suggestion lacks understanding of what it takes to solve the problems of obesity, high blood pressure and diabetes and focuses only on sugar-sweetened beverages as the cause of the problem.

To adopt this measure in the belief that it will deter the consumption of such beverages and, therefore, address obesity would be a great disservice to all as the problem is multifaceted. Adoption of this suggestion in the belief it will prevent this disease reflects ignorance of the problem.

b) Institute a Carbon Tax.

This proposal relies on a Brookings Institution report to estimate that the State could generate more than $360 million annually in carbon tax revenues, if a carbon tax were imposed on the burning of carbon-based fuels such as coal, oil, or gas. This would be in addition to the taxes now imposed on fuel under chapter 243, HRS, as well as by the counties.

The Draft Report acknowledges that no state to date has enacted a carbon tax, but states that Hawaii would be the perfect state to exhibit “national leadership” in this area. Which is another way of saying that if this tax is enacted in Hawaii, the Department of Taxation would have no clue how to administer or enforce it; it would have to start from ground zero. There would be no assurance whatsoever that the $360 million would magically appear in the State’s coffers. And, no one would know or be able to inform the populace about what secondary economic effects could be expected, such as a major jump in electric rates given that most electricity in Hawaii is produced by burning bunker fuel.

5. Changes to Improve System Administration Collection.

a) Develop tax gap systems to identify under-payment and non-payment of taxes.

This recommendation, along with the next, is an integral part of the Department’s need to upgrade its technology systems. That said, it should be remembered that conformity with the federal Code with respect to the net and gross income taxes will go a long way in accomplishing this goal. The more the state diverges from conformity, technology will be less likely to bridge the gap easily and will be more likely to be expensive.

b) Expand efforts to Incent E-Commerce Collection of GET.

The United States Constitution has been interpreted as providing two limits on the states' powers to tax. These limits come from at least two places: first, the Due Process Clause, requiring a person to have "minimum contacts" with a state before that state is allowed to exercise police powers, including the power to tax, against that person; and second, the Commerce Clause, where the Supreme Court held in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), that if the Congress does not otherwise define the threshold for taxability, state tax may not be imposed upon a person unless there is "substantial nexus" with that person. Substantial nexus is more than minimum contacts, and Quill Corp. v. North Dakota, 504 U.S. 298 (1992), appears to stand for the proposition that some physical presence is needed to establish substantial nexus.

In Hawaii, section 237-22(a) HRS, states that there shall be excepted or deducted from the values, gross proceeds of sales, or gross income so much thereof as, under the Constitution and laws of the United States, the state is prohibited from taxing, but only so long as and only to the extent that the state is so prohibited. *In re Grayco Land Escrow, Ltd.*, 57 Haw. 436, 559 P.2d 264, *cert. denied*, 433 U.S. 910 (1977), established that Hawaii already extends its general excise and use taxes to reach the limit of the Constitution ("Thus, in plain and unmistakable language, the statute evidences the intention of the legislature to tax every form of business, subject to the taxing jurisdiction, not specifically exempted from its provisions.").

This recommendation is, of course, trying to address the problem, faced by all states that have enacted sales and use taxes, about collecting sales and use taxes on remote sellers. A seller with no physical presence in a customer's state might see no obligation to collect and remit tax in the customer's state. The customer would be liable for use tax, but tax departments throughout the country have met with little success in motivating such customers, especially those with small purchases, to pay use tax.

Colorado came up with an interesting solution to its problem. They figured they couldn't make all retailers collect and pay the tax over. However, they did pass a law saying that if a retailer selling to a Colorado consumer doesn't pay the tax, it must do three things. First, the retailer must advise the consumer that Colorado use tax is due on the purchase. Second, the retailer must send a summary of all purchases made during the year to the consumer if those purchases total $500 or more. Third, the retailer must send a summary to the Colorado Department of Revenue similar to IRS Form 1099 reporting requirements. Penalties are imposed against noncompliant retailers. The penalty amount is $10 per purchaser for failing to send the purchaser statement, and $10 per purchaser that should have been included in a report for failure to file the statement.

The Direct Marketing Association, or the DMA, whose members include many online retailers, sued in federal court asking for an injunction against enforcing these requirements, which they contended were discriminatory and unconstitutional. The U.S. District Court found them to be an undue burden on interstate commerce and granted a permanent injunction. The Department of Revenue appealed to the Tenth Circuit. After a trip to the U.S. Supreme Court, the Tenth Circuit reached the merits and upheld the statute. *Direct Marketing Association v. Brohl*, No. 12-1175 (10th Cir. Feb. 22, 2016). The Supreme Court denied review on December 12, 2016.

Another approach to this problem follows what the Multistate Tax Commission has recommended, and many states have enacted, “factor presence nexus” standards saying that nexus should be found when a taxpayer has a significant dollar amount of sales activity in the state, and these standards have motivated some of the larger remote sellers to agree to collect and remit sales and use taxes on that activity.

Specifically, it was recently announced that Amazon, the online retailer, will be collecting and remitting Hawaii tax on online purchases effective April 1, 2017. If proposed legislation such as this is motivating online sellers to come to the table, enacting the legislation may well have its desired effect.

Thank you for the opportunity to submit comments.

Very truly yours,

Thomas Yamachika

Thomas Yamachika
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