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HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT & BUSINESS CONCERNS
TESTIMONY REGARDING HB 1629
RELATING TO CORPORATE INCOME TAX

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: FEBRUARY 5, 2008
TIME: 8:30AM
ROOM: 325

This legislation proposes to repeal the corporate income tax, effective for the 2007 taxable year.

The Department of Taxation (Department) and the Lingle-Aiona Administration **strongly support** this measure and encourage the Committee to pass this measure for further consideration.

I. THE DEPARTMENT STRONGLY SUPPORTS STREAMLINING BUSINESS REGULATION AND ELIMINATING THIS BURDEN ON HAWAII COMPANIES.

The Department strongly supports this measure because Hawaii has received a reputation as a cumbersome state to conduct business with an environment wrought with regulation. Through the Administration has worked diligently over the past six years to minimize business regulation, the taxation on businesses remains very high.

The Department strongly supports repealing the corporate income tax for the following reasons—

AN INEFFICIENT REGULATION ON BUSINESSES—The corporate income tax in general is a very inefficient tax regulation. Corporate income tax is inefficient because it creates large burdens on businesses while raising little revenue for the government. Tax revenues have gotten smaller because states provide large incentives that reduce tax through credits, which further distorts the true impact of taxes, including fairness. Evidence suggests that eliminating the tax altogether could be a better approach then a tax with many incentives that reduce the burden to a point where the revenue generated by the tax are ineffective.

HIGH COMPLIANCE COSTS—The corporate income tax is typically a very large

compliance cost for companies. The tax also influences corporate decisions-making and behavior. For example, corporations that have the ability to zero out their corporate tax through expenditures have creatively sheltered income tax liability through aggressive schemes and other tax shelter devices.

ENCOURAGES EXODOUS OF BUSINESS ACTIVITIES—With the technology available in today's modern society, it is now feasible (if not cheaper) for corporations to restructure their business operations to carry out production, distribution, sales, and other activities in various states based upon which states have the most favorable tax laws for each respective activity. For example, a business could carry out production in Ohio with favorable manufacturing incentives; sales and distribution in Montana with no sales tax; and general operations in Washington State with a relatively small Business & Occupation tax and no income tax. Hawaii taxes each one of these business activities, which adds to the complexity and the suggestive evidence that businesses are leaving Hawaii in some shape or form due to business environment.

DIFFICULT ADMINISTRATIVE RESOURCE DRAIN—From a tax administration standpoint, the corporate income tax is also a drain on resources. The Department routinely dedicates training and personnel to determining whether a business has sufficient "nexus" to tax a business. The nexus question is one of the most complex tax issues for state and local taxation and leads to the State spending hundreds of thousands on litigation costs to settle disputes. The use of the Uniform Division of Income for Tax Purposes Act is very helpful in resolving this, but the nexus issue still remains.

STALLS CORPORATE EXPANSION & INVESTMENT IN OPERATIONS AND PERSONNEL—The corporate income tax also precludes businesses from expanding in the State. If a branch division or office could be set up elsewhere, a tax friendly state would likely be the choice. The tax also minimizes the capital that a business has to keep their operations up-to-date. And, capital is taken away from the ability to hire personnel or provide raises or otherwise spread the corporate wealth throughout those that run the businesses.

II. TAX REVIEW COMMISSION STUDIED THIS CONCEPT

The Department also points out that the economics of eliminating this tax are as follows, which were studied by the Tax Review Commission's 2005 report:

1) In the long run, the tax is paid entirely by Hawaii residents. It cannot be shifted to out-of-state shareholders.

2) The adverse effects on local wages and land rents are greater than the amount of direct taxes on wages and rents that would be needed to replace the corporate income tax revenues.

3) For these reasons, the 2005-2007 Tax Review Commission recommended eliminating Hawaii's corporate income tax. (See recommendation E 1 on page 19 of their Report.)

4) The effect on the tax structure would not be great – corporate tax collections in fiscal year 2007 were only about $82 million.
5) Hawaii does not need the corporate income tax to backstop the net income tax (to prevent people from deferring tax liability by incorporating), because the federal corporate income tax is sufficient for this purpose.

Academic literature on the issue is cited in footnote 18 of the Report of the 2005-2007 Tax Review Commission.

III. EFFECTIVE DATE

The Department points out that this bill currently applies to taxable years beginning after December 31, 2006. This is retroactive and would result in tax refunds for the entire 2007 taxable year. This result could result in administrative difficulty.

IV. REVENUE IMPACT

This legislation will result in a revenue loss of approximately $81.8 million per year.

In order to insulate the general fund from such a loss of revenue at one time, the Department strongly suggests that the Committee amend the measure to phase-out the corporate income tax over a period of five years.

As a result, the Department strongly suggests this measure be passed out of committee for further consideration.

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TAXBILLSERVICE

126 Queen Street, Suite 304 TAX FOUNDATION OF HAWAII Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Repeal corporate income tax

BILL NUMBER: HB 1629; HB 1783 (Identical)

INTRODUCED BY: HB 1629 by Yamashita and 1 Democrat; HB 1783 by Lee

BRIEF SUMMARY: Repeals HRS chapter 235, part IV, and amends other sections of HRS chapter 235 to repeal the corporate income tax and references to corporate income taxation.

Requires the revisor of statutes to submit a report to the 2008 session of the legislature identifying other conforming amendments to the statutes that should be made to effect the repeal of the corporate income tax.

EFFECTIVE DATE: Tax years beginning after December 31, 2006

STAFF COMMENTS: This measure would repeal the Hawaii corporate income tax as recommended by the most recent Tax Review Commission. To the extent that corporations in Hawaii would not be subject to corporate income taxation, they would still need the services provided by state government so those services must be paid for by someone else. Thus, the enactment of this measure may result in an increase in individual income tax rates or other taxes to make up the loss of revenues to pay for basic services provided by government unless a commensurate reduction in spending is also undertaken.

If the intent of this measure is to improve the perception of Hawaii as a place to do business, then repealing the corporate net income tax would certainly make Hawaii stand out among all the other states which impose a net income tax on corporate profits. However, it should be remembered that not all businesses pay the net income tax under HRS 235 but some pay an in-lieu tax such as the banks which pay the financial institutions tax under HRS 241 and insurance companies which pay the insurance premiums tax under HRS 431 in-lieu of the net income and general excise tax. It should also be noted that in recent years, the corporate income tax has contributed a wildly fluctuating share to the state general fund. While the corporate income tax contributed just over $130 million for the fiscal year 2006, net corporate income tax collections as recently as fiscal year 2003 amounted to less than $9 million.

If the intent of this measure is to truly improve the tax climate as opposed to merely creating a perception, then the focus is misplaced. The most onerous of taxes imposed on businesses is the general excise tax as it is a tax on gross income and is paid without regard to a business' profitability. Thus, a business may be losing money or selling its goods or services at a loss, but it is still responsible for the general excise tax.

The other onerous tax on business in Hawaii is not a tax per se, but the numerous regulations imposed by government and the plethora of fees and licences that a business must secure to do business in Hawaii. During the years when general fund tax collections were sparse, lawmakers resorted to all sorts of new fees and user charges arguing that those who receive a direct benefit from a government service should

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pay for them. In many cases the cost of the fee eclipsed the cost of providing the service or in other cases, those public services used to be funded with general taxes. Thus, when collections of the BIG taxes, like the income tax and the general excise tax waned, the burden was shifted to user fees and charges and to the cost of securing the appropriate licenses and approvals from government regulators. Now that the economy seems to be humming along, healthy and vibrant, as reflected in the ebullient tax collections, one must ask whether those user fees and charges are necessary and what are the BIG taxes funding if not the services that are being funded with the user charges and fees? If the business climate in Hawaii is to improve, then it is these costs that must be addressed.

Digested 1/31/08

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