LINDA LINGLE
GOVERNOR

JAMES R. AIONA, JR.
LT. GOVERNOR

KURT KAWAFUCHI
DIRECTOR OF TAXATION

SANDRA L. YAHIRO
DEPUTY DIRECTOR

STATE OF HAWAII
DEPARTMENT OF TAXATION
P.O. BOX 259
HONOLULU, HAWAII 96809

PHONE NO: (808) 587-1510
FAX NO: (808) 587-1560

SENATE COMMITTEE ON ECONOMIC DEVELOPMENT & TAXATION

TESTIMONY REGARDING SB 2240
RELATING TO TAXATION

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: JANUARY 29, 2008
TIME: 1:15AM
ROOM: 224

This Bill would provide qualified Hawaii taxpayers with an earned income tax credit (EITC) equal to 20% of the federal EITC.

The Department of Taxation ("Department") **appreciates the intent of alleviating the tax burden of those who need it most; however prefers adoption of the Administration's tax relief measure of increasing the standard deduction, SB 1493, a carry-over measure from last session**.

This bill provides for a refundable tax credit equal to 20% of the EITC allowed under section 32 of the Internal Revenue Code (IRC) and reported on these qualified individuals' federal income tax returns. The bill requires the Department to alert eligible taxpayers of the proposed Hawaii EITC and prepare an annual report containing certain information.

I. ADMINISTRATION MEASURE MORE EFFECTIVE.

The Department strongly supports the Lingle-Aiona Administration measure of increasing the standard deduction because it would help more Hawaii taxpayers. The Administration measure SB 1493 would increase the standard deduction to 75% of the federal 2005 standard deduction. For example, SB 1493 would increase the standard deduction for a joint return from $4,000 to $7,500. It is estimated that 64% of Hawaii's taxpayers will benefit from the Administration's increasing the standard deduction. The Administration measure to increase the standard deduction provides $30 million in tax relief per year and leaves this money in the pockets of those who need it most.

In comparison, this legislation will only assist roughly 68,560 taxpayers or less than l3%. This legislation only provides approximately $23.8 million in total tax relief with a claimed benefit of $347 per taxpayer, assuming a 20% Hawaii earned income tax credit.

II. COMPLIANCE PROBLEMS.

The Internal Revenue Service (IRS) admits that the EITC has been plagued by persistent compliance problems. The IRS has been unable to reduce noncompliance problems significantly. Between $8.4 and $9.9 billion (27% to 32%) in EITC claims have been paid improperly as reported in a compliance study of tax year 1999 returns. The EITC credit is listed as a "*high risk area for the federal government*" by the General Accounting Office. *See EITC Reform Initiative*, FS-2003-14, June 2003). In its 2005 EITC Initiative Final Report to Congress, the IRS stated that although "the IRS has implemented a number of legal and administrative changes since [the 1999 study], IRS officials believe the error rate is still substantial." The 2005 report, in an analysis of preliminary data from tax year 2001 returns stated that EITC over claim estimates would not be "substantially different" than that of tax year 1999. *See http://www.irs.gov/pub/irs-utl/irs_earned_income_tax _credit_initiative_final_report_to_congress_october_2005.pdf.*

The Department recognizes that the data cited by the IRS is based upon 1999 tax year returns. However, complex studies of enforcement and compliance data take many years and necessarily must rely on closed tax years to make a proper measurement. In attempts to bring fresh data to the Committee's attention, the Department offers for its consideration statistics available from ExpectMore.gov. This website maintains certain statistics on the EITC program. For example, the EITC Program Performance Measurement provides the "[p]ercent of EITC dollars paid that should not have been paid...based on random audits. 2001 is the latest available data." The explanation of error rates, including projections, is as follows:

Year	**Target**	**Actual**
1997		**24 to 26%**
1999		**27 to 32% (cited above)**
2001		**30 to 34%**
2006	**28% (projected)**	
2007	**28% (projected)**	

As can be seen from these statistics, the EITC has been a consistent compliance problem for the past decade. Moreover, based upon projections, noncompliance is likely to remain around the one-third level. Considering the chance that one-third of the claims may be put at risk of fraud by adopting a conforming EITC, the Department again recommends the Committee consider adopting the Administration's increased standard deduction in the alternative.

"The EITC credit is a social welfare program embedded in the tax code where the tax system primarily relies on self-reporting." (*See EITC Reform Initiative*, FS-2003-14, June 2003). Unlike other social welfare programs, no requirement is imposed for EITC eligibility proof prior to payments and the payments rely on the claimants' self-assessment for eligibility. Crucial EITC eligibility factors such as marital status, residency, and the relationship test of a claimed child, are difficult for the IRS to confirm. *See id*.

On the other hand, the Administration measure of increasing the standard deduction is easy to implement and is not encumbered with the EITC noncompliance problems discussed above.

III. <u>TAX BENEFITS TO TAXPAYERS DO NOT OUTWEIGH UNDUE</u>

ADMINISTRATIVE BURDEN.

IMPACTS TOO FEW—The EITC tax benefits do not outweigh the administrative burden. The Federal EITC is only available to taxpayers who meet the eligibility criteria. To name a few, the taxpayers must have earned income and cannot exceed the earned income ceiling; must be between 25 to 65 years old; and must not file "married filing separate returns".[1] The tax benefits provided by the EITC program do not cover the wide range of taxpayers, which is accomplished by the Administration measure of increasing the standard deduction. For example, the EITC phases out at the following levels—

Number of Children	Filing Single	Filing Joint
0	**$12,590**	**$14,590**
1	**$33,241**	**$35,241**
2 or more	**$37,783**	**$39,783**

ADMINISTRATIVE BURDEN—The bill would place an administrative burden on the Department due to the high rate of noncompliance with respect to the Federal EITC claims. The requirement of the Department alerting eligible taxpayers of the proposed Hawaii EITC would also place an adverse administrative burden on the Department. Due to the unclear and incomplete annual reporting requirements set forth in this bill and the existing annual reporting of tax credits claimed by Hawaii taxpayers, the Department would be unduly burdened in compiling duplicate reports.

For the reasons set forth herein, the Department believes the Administration tax relief measures are more favorable and respectfully requests this Committee to consider the Administration's measures in the alternative to the bill.

IV. REQUEST FOR APPROPRIATION.

This bill requires the Department to alert taxpayers to the ability to claim this credit. Public outreach costs could be substantial in order to provide adequate notice of this tax credit. Moreover, given the high fraud costs associated with this bill, the Department will likely focus audit efforts toward fraudulently claimed EITC credits. As a result, the Department respectfully requests a reasonable appropriation for the costs of implementing the public outreach and fraud mitigation efforts.

V. REVENUE ESTIMATE.

This legislation will result in revenue loss of approximately $23.8 million annually, assuming a 20% conformity to the federal EITC.

1 The Department suggests that the provision in the bill allowing a husband and wife to file separately and claim the credit be eliminated.

HACBED

Hawai`i Alliance for Community-Based Economic Development
677 Ala Moana Blvd., Suite 702 Honolulu, HI 96813
Ph. 808.550.2661 Fax 808.534.1199
Email info@hacbed.org www.hacbed.org

January 29, 2008

Economic Development and Taxation
January 29, 2008 1:15pm
CR 224
SB 2240 SUPPORT

Dear Chair Fukunaga and Committee Members:

The Hawai`i Alliance for Community Based Economic Development (HACBED) is submitting testimony in support of **SB 2240**.

Hawai'i needs comprehensive public policy to help people build assets. This should include a combination of programs, tax incentives, regulatory changes, and other mechanisms to help people earn more, save more, protect hard earned assets, start businesses and realize the dream of homeownership. HACBED supports **SB 2240** in that this bill is a major component of a larger asset building policy package. The 2008 Ho'owaiwai Asset Policy agenda addresses these needs by putting together a comprehensive package of policies that encourages and widens opportunities for asset building.

Assets are essential for three reasons:

1. To have **financial security** against difficult times

2. To create **economic opportunities** for oneself

3. To **leave a legacy** for future generations to have a better life

To date, 23 states (including the District of Columbia) have enacted ETIC's. These states will combine for close $2 billion to nearly 6 million families. **EITC's put money back into the community where it is needed most.**

Hawai`i's families continue to struggle to provide the very bare necessities. Many are burdened with the high day to day costs of living not to mention the need to save for college, a new home, a small business or starting a family. These families need tools for building assets- EITC's provide an opportunity to do so.

For most tax payers, their annual refunds from both federal and state fillings are the largest lump sum of discretionary funds they ever see. These funds can be used for home down payments, debt reduction, creation of Individual Development Accounts, and rainy day funds.

How would a state EITC work?

SB 2240 establishes a state EITC that is similar to the 23 other states that utilize the credit. Hawai`i individual filers that qualify for a federal EITC may claim 20% of the earned income credit allowed and reported on the individuals' federal income tax return. Filers have already been utilizing tax preparation assistance from Aloha United Way since the incorporation of the federal EITC and will be provided the same opportunity should a state EITC become available to them. It is key to note that these credits encourage timely filing and offer an opportunity to educate filers on the importance of early filing and financial planning.

In closing, Hawai`i families are struggling to provide for their families given the high cost of living across the state. They are overburdened by taxes and have few opportunities to build their assets and work toward self-sufficiency. Low wages mean pay check to pay check living and an uncertain future. A state EITC will help the working families in Hawai`i who need it the most. It provides a targeted tax relief for these families when they need it most.

Thank you for your consideration.

Sincerely,

Justin Fanslau
Associate Director

Aloha United Way

200 N. Vineyard Blvd., Suite 700
Honolulu, Hawaii 96817-3938
Telephone (808) 536-1951
Fax (808) 543-2222
www.auw.org

United Way
Aloha United Way

January 25, 2008

Senate Committee on Economic Development and Taxation
Senator Carol Fukunaga, Chair
Senator Will Espero, Vice Chair
Conference Room 224
Tuesday, January 29, 2008, 1:15 PM

SB 2240 – Strong Support

Dear Chair Fukunaga, Vice Chair Espero and Committee Members:

Aloha United Way strongly encourages your favorable consideration of SB 2240 which establishes a refundable state earned income tax credit.

In 2007, AUW commissioned a report by the University of Hawaii's Center on the Family to look at the critical issue of Family and Individual Self-Sufficiency. We define self-sufficiency as the ability to meet basic needs without government or other subsidies. The report clearly shows the impact of the ever-increasing cost of living in Hawaii on a workforce that is less and less able to achieve self-sufficiency. For instance, the report shows that only two out of the top 25 occupations in Hawaii pay a self-sufficient wage – and those top 25 occupations include over 227,000 workers or 40% of Hawaii's workforce.

The federal earned income tax credit has proven to be the most efficient and effective way of providing tax relief to low income working families. This credit has lifted over 4.4 million Americans out of poverty every year. SB 2240 establishes a state earned income tax credit modeled after the federal credit and sets the state credit at 20% of the federal credit. While our current "income-support" based welfare system is important to ensure our most needy are cared for, moving families from support to self-sufficiency requires a comprehensive set of asset building strategies – and a state earned income tax credit is a powerful tool to target those who are emerging from reliance on state support programs.

SB 2240 provides an excellent start on a comprehensive set of programs that will eventually enable more of our citizens to enjoy a self-sufficient life and Aloha United Way strongly encourages favorable consideration of this important legislation.

Sincerely,

Susan Doyle

Susan Doyle
President & Chief Professional Officer

L E G I S L A T I V E

TAXBILLSERVICE

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

SUBJECT: INCOME, Earned income credit

BILL NUMBER: SB 2240; HB 2379 (Identical); HB 2654 (Similar)

INTRODUCED BY: SB 2240 by Chun Oakland, Ihara, Gabbard, Sakamoto and Espero; HB 2379 by Shimabukuro; HB 2654 by Belatti, Brower, Luke, Nishimoto, Takai, Takumi

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to allow taxpayers to claim a state earned income tax credit equal to 20% of the federal earned income tax credit amount. HB 2654 does not specify a percentage.

Credits in excess of tax liability shall be refunded to the taxpayer provided such amounts are over $1. The director of taxation may adopt rules pursuant to HRS chapter 91 and prepare the necessary forms to claim the credit and may require proof of the claim for the credit. Requires claims, including any amended claims, to be filed on or before the end of the twelfth month following the taxable year for which the credit may be claimed.

Directs the director of taxation to prepare an annual report containing the number of credits granted for the prior calendar year, the total number of credits granted, and the average value of the credits granted to taxpayers whose earned income falls within various income ranges.

EFFECTIVE DATE: Tax years beginning after December 31, 2007

STAFF COMMENTS: The federal earned income tax credit (EITC) provides an incentive to low-income households to remain in the workforce. The credit is targeted at households with children but the credit is also available at a lower amount to low-income households without children. The credit is based on a number of tests for earned income, investment income, number of qualifying children, dependency, etc. Given the complexity of the credit, the IRS will optionally calculate the amount of the credit for taxpayers. The IRS reports an error rate of greater than 25% for this credit.

The proposed measures would adopt an earned income credit by merely taking a percentage of the amount that the taxpayer would be eligible for under the federal table or determination. It should be remembered that the federal EITC was established at the federal level for low and moderate-income workers to offset the burden of Social Security payroll taxes that might have otherwise been paid to them but were instead paid to the federal government by the employer. Enacted in 1975 at the federal level primarily as a means of tax relief, the credit was expanded three times during the 1980's and 1990's by the federal government to boost income from work and lessen poverty among families with children. In other words, it became a tool by which the federal government undertook social policy beginning with the first expansion of the credit in 1986. It is interesting to note the date of the first expansion because that was also the year that the federal Code was dramatically restructured, eliminating a number of tax benefits such as the deduction of consumer credit interest, deduction of state sales taxes, and institution of a minimum tax for those taxpayers receiving generally exempt income. It was also the year that rates were dramatically reduced, and together with the standard deduction and personal exemption, rates were indexed.

Thus, what started out as a mechanism to "refund" payroll taxes that might otherwise have been paid to low and moderate-income workers by the federal government has turned into a subsidy for these families. While federal policymakers have the luxury of expending millions of dollars to accomplish a social goal through the tax system, state lawmakers do not have the same level of resources.

If the intent of state lawmakers is to alleviate the burden on the low and moderate-income workers in Hawaii who claim the federal EITC, their efforts should focus on the state income tax burden as it affects these families. Hawaii has one of the lowest thresholds of the some 43 states that levy a state income tax. An income tax threshold is the income level at which families begin to pay the state income tax. Despite the reduction in personal income tax rates in 1998 and adoption of a low-income tax credit, as well as a modest increase in the standard deduction, much more work needs to be done to adjust the standard deduction and the personal exemptions. Rates and brackets are still much too high for all of Hawaii's working people.

While advocates point to a variety of national articles that hail the EITC as a means of helping the poor out of poverty and encouraging the poor to go to work, they miss the point that taking a percentage of the federal amount bears no relationship to the tax burden imposed by the state. Thus, the EITC amounts to nothing more than a back door welfare program, handing out money merely because a person falls into a low-income category and has joined the workforce with a dependent or two. So while welfare advocates may point to tomes of literature that praise the EITC as a way to lift the poor out of the abyss of poverty, there is just as much material that decries the EITC as poor tax policy and one that is fraught with errors and compliance difficulties. In other words, if the poor are to be helped, don't do it through the tax system as there is very little transparency and accountability. And despite claims that many of these problems have been resolved, there is general agreement from administrators and practioners that this is one of the most difficult and complicated federal tax credits with which to administer and comply, with increasing errors and inaccuracies.

Like many of the targeted tax credits aimed at encouraging business activities, the EITC comes with all of the problems outlined with those targeted business tax credits. There is no oversight as to how these refunds are aiding families, whether or not outcomes are being achieved or for that matter whether a family is getting sufficient assistance to actually leave the welfare rolls and become self-sufficient. As a recent study reported, nearly one-third of Hawaii's families are not self-sufficient. What will the EITC do for those families who are working two or three jobs to make ends meet but, as a result, make too much money to qualify for the EITC? Where is the tax relief for those families? Lawmakers can make much more of a difference by making the needed structural changes to the state income tax rates and brackets and by boosting the standard deduction. Again, one must ask what is the relationship between taking 20% of the federal credit amount and the amount of state tax burden relieved?

Lawmakers should also consider the interaction of a state tax credit that produces negative income and how that would affect the amount of income that would then be exposed to the federal rate structure. There are comprehensive studies on the interaction of the credit with the overall federal income tax system. Adopting the credit willy-nilly for state tax purposes may disrupt the incentive to remain employed or to increase the number of hours worked. It should be noted that an EITC has not been recommended by the latest state Tax Review Commission (TRC). The TRC examined the effects of what would have happened if an EITC was enacted equal to 20% of the federal EITC in 2006. Based on 2003 tax returns, the staff of the Tax Research and Planning Office of the department of taxation found that fewer than half of the Hawaii resident income tax returns would have benefited from a Hawaii EITC. Of the 308,652 returns with AGI of under $30,000, only 68,845 or 22.3% claimed the federal EITC. They also estimated that there would be a $23.2 million decline in tax collections if the EITC were adopted.

Finally, lawmakers should understand that by taking a percentage of a number calculated at the federal level, they are surrendering their oversight over this tax policy to Congress. What is even scarier is that Congress could choose to substantially increase the amount of the credit such that the result at the state level may mean a huge unexpected impact on state resources. Such is the case with the state inheritance taxes which were tied into the tax credit offered under the federal law which calculated an amount the federal government assumed the state took in death taxes. However, this provision was eliminated by EGTRRA in 2001, phasing out the state death tax credit completely over four years such that Hawaii has no tax on inheritance and estates.

Finally, where would the revenue loss generated by this credit be taken? Which program would be cut or not funded at all. What is known in the social services community is that unless the poor are given the tools and skills to become self-sufficient they will remain on welfare. The funds lost in this tax credit program would be far better spent on services that assist those especially in public housing in gaining the skills they need to hold gainful employment, provide child care so those who need to go to work will have childcare, and learn how to manage what money they earn. Without these skills, merely subsidizing their earned income with a tax credit will not hold a promise of self-sufficiency. Rather than duplicating the federal earned income tax credit, the state should use its resources to instead complement the effort with more skill building and family support so these families can hold gainful employment.

Digested 1/25/08

The Twenty-Fourth Legislature
Regular Session of 2008

THE SENATE
Committee on Economic Development and Taxation
Senator Carol Fukunaga, Chair
Senator Will Espero, Vice Chair

State Capitol, Conference Room 224
Tuesday, January 29, 2008; 1:15 p.m.

STATEMENT OF THE ILWU LOCAL 142 ON S.B. 2240
RELATING TO TAXATION

The ILWU Local 142 supports S.B. 2240, which creates a refundable state earned income tax credit for individual taxpayers equal to 20% of the federal earned income tax credit.

The Earned Income Tax Credit was designed by the Federal Government to provide additional income to low wageearners, allowing them an opportunity to begin saving for their future. Of course, because of the high cost of living, many who take the EITC will use the extra money for daily necessities instead of building a nest egg for future use. However, the concept of government providing low wageearners with the means to build assets is commendable.

Similarly, S.B. 2240 provides a means for the State to do the same. In a simplified formula, under S.B. 2240, the State will allow low wage taxpayers to get a refundable tax credit equal to 20% of the tax credit claimed on their federal tax return. Not only is this an incentive to work, but it can be a means for some to lift themselves out of poverty.

The biggest concern will be getting low-income families to file for the federal and state tax credit. However, this may be a problem that can be overcome with support from labor unions, community organizations, government agencies, and nonprofits. The first step is to have the Legislature enact a State EITC.

The ILWU urges passage of S.B. 2240. Thank you for the opportunity to provide testimony on this matter.

LEGAL AID
SOCIETY OF HAWAI'I

Telephone: (808) 536-4302, Fax: (808) 527-8088
924 Bethel St.
Honolulu, HI 96813

George J. Zweibel, Esq.
President, Board of Directors

Charles K. Greenfield, Esq.
Executive Director

TESTIMONY IN SUPPORT OF SB2240
RELATING TO TAXATION

LATE TESTIMONY

January 29, 2008 at 1:15 p.m.

The Legal Aid Society of Hawaii hereby provides testimony to the Committee on Human Services and Housing on SB2240 - Relating to Taxation, in support of the bill.

Founded in 1950, the Legal Aid Society of Hawaii is the oldest provider of legal services in the state.. We provided civil legal assistance to low-income individuals through nine offices located in Lihue, Waianae, Honolulu, Kahaluu, Kaunakakai, Lanai City, Wailuku, Kona and Hilo. Over the years we have seen the benefit of linking community based economic development and asset building to legal services as critical to assisting our clients out of poverty.

In Hawai'i, 1 in 4 people live below 200% of the federal poverty guideline ($47,496 for a family of four). However, a recent study by the Center on the Family at the University of Hawai'i found that in 2005, it took $57,893, or $4,824 per month, to cover the basic living expenses for a family with two adults, one school aged and one pre-school child living in Honolulu[1].

We believe that a refundable state earned income tax credit is one the best means to make a significant impact on assisting working poor families out of poverty. A state earned income tax credit would encourage work and provides a supplement to assist families that are working hard, but barely making it in our state.

Thank you for this opportunity to testify.

Sincerely,

M. Nalani Fujimori
Deputy Director
527-8014

[1] This figure increases to $58,635 on Kauai and $63,257 in Maui County. The figure is slightly lower in Hawai'i County at $53,909.