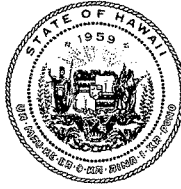


LINDA LINGLE
GOVERNOR

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

**HOUSE COMMITTEE ON FINANCE
TESTIMONY REGARDING HB 1494
RELATING TO TAXATION**

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: FEBRUARY 26, 2009

TIME: 1PM

ROOM: 308

This measure provides for a cap on itemized deductions and also increases the standard deduction.

The Department of Taxation (Department) **supports the concept of increasing standard deduction**; however has **concerns regarding capping the itemized deduction for state taxes paid**.

LIMITING THE DEDUCTION FOR STATE TAXES PAID—The Department understands that this measure was intended to cap the amount of the deduction for state taxes paid. As written, this measure does not accomplish this goal. Also, the Department has administration concerns with the sliding scale application of the deduction limitation. The Department would prefer a flat cap.

INCREASING THE STANDARD DEDUCTION—The Department supports increasing the standard deduction to more accurately reflect Hawaii's high cost of living. Increasing the standard deduction is the simplest and most effective way to provide meaningful tax relief to the poor by ensuring that they are not taxed in the first place. The standard deduction is simple and efficient and is not subject to manipulation or fraud like other low-income tax relief proposals. Though the Department supports increasing the standard deduction, the cost of such an amendment needs to be made up through other means.

EFFECTIVE DATE—The Department is concerned with the effective date and the lack of time to overhaul the Department's computer and forms in time for the 2009 tax season.

REVENUE IMPACT—This measure will result in a revenue gain of \$23 million per year.

TAXBILLSERVICE

126 Queen Street, Suite 304

TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Limit itemized deduction, increase standard deduction

BILL NUMBER: HB 1494

INTRODUCED BY: Chong, Herkes, Mizuno, Yamane, and 1 Democrat

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to provide that itemized tax deductions under the state income tax shall not exceed income of: (1) \$100,000 for taxpayers filing a joint return or as a surviving spouse; (2) \$80,000 for taxpayers filing as a head of household; (3) \$50,000 for taxpayers filing as an unmarried individual or not as a surviving spouse or not as a head of household; or (4) \$50,000 for taxpayers filing as a married individual filing separately.

Amends HRS section 235-2.4(a) to increase the standard deduction: (1) from \$4,000 to \$4,400 for taxpayers filing a joint return or a surviving spouse; (2) from \$2,920 to \$3,210 for taxpayers filing as a head of household; (3) from \$2,000 to \$2,200 for those filing as an unmarried individual; or (4) from \$2,000 to \$2,200 for taxpayers filing as a married individual filing a separate return.

EFFECTIVE DATE: Tax years beginning after December 31, 2008

STAFF COMMENTS: While it is not inherently clear what this measure proposes to do in limiting how much a taxpayer may take as itemized deductions, the insertion of the word "income" after the verb "shall not exceed" creates a couple of possible interpretations. Are the sponsors proposing that in the case of a joint return the amount of itemized deductions that can be taken is limited to \$100,000 or is it the joint filers itemized deductions are somehow limited once the income reported on the joint return exceeds \$100,000. While it appears that the proposed measure is to impose a limit on the amount of itemized tax deductions that may be claimed, as drafted, the measure provides that the itemized tax deductions claimed "shall not exceed income of \$100,000 in the case of a joint return..." If the measure is enacted in this form, it is questionable whether it would achieve the intent of the measure that is to "provide socioeconomic fairness and equity in the state tax system."

At the federal level, taxpayers with large adjusted gross income see some of their itemized deductions limited. The types of itemized deductions which are pared by the limit include deductions for: taxes, interest paid, charitable contributions, job expenses and certain other miscellaneous deductions. Those itemized deductions which are not limited because of high incomes include: medical and dental expenses, investment interest expenses, casualty and theft losses, and gambling losses. If this is the goal of this particular proposal, then consideration might be given to patterning it after the federal application. At least this would be one step closer to conformity in this area although the legislature could set different adjusted gross income thresholds as the state income tax rates are not as high as the federal rates.

This measure also proposes to increase the standard deduction. Under the federal law, for tax years beginning in 2008 the standard deduction is \$10,900 for joint returns or surviving spouse, \$8,000 for head of household, \$5,450 for individuals and for married filing separately. Note that the federal standard

deduction amounts are substantially higher than the amounts provided by the state due to two primary reasons. Federal marginal income tax rates are higher than state tax rates. Also, the approach to improve tax equity within the respective tax systems differs. The federal standard deduction was increased to remove most low-income households under the poverty line from the tax rolls. By increasing the state standard deduction at this time, a similar goal can be achieved. Removing the truly poor from having to deal with the income tax would also reduce the amount of paperwork for the department of taxation. It would also reestablish the philosophy that there should be a certain level of minimum income that is necessary for subsistence that should not be subject to tax.

The standard deduction was last increased by Act 110, SLH 2006, to 40% of the federal standard deduction at that time. Increasing the standard deduction has been a continual litany of every Tax Review Commission since the body was established in the state constitution, including the most recent Tax Review Commission of 2005-2007.

The standard deduction basically raises the floor before which families have to begin paying the income tax. While the 2006 legislature raised the state standard deduction at 40% of the federal amount effective for the tax year beginning January 1, 2007, it should be noted that the amount used to calculate the new standard deduction was the amount effective for the 2005 federal return. Since the federal amounts are indexed or adjusted for inflation, it puts the state standard deduction even farther behind the federal standard deduction. Thus, if lawmakers truly want to help those at the bottom end of the income scale, another adjustment of the standard deduction is in order. While the specific dollar amounts or the ratio to the federal standard deduction is a legislative prerogative, raising the standard deduction is the most simple and direct means of aiding the poor and lower middle-income families. Upper income families generally itemized their deductions as those deductions are probably greater than the standard deduction amount.

Another consideration should be indexing of the standard deduction which was also recommended by the most recent Commission. It should also be noted that the federal system is indexed for inflation to prevent nominal price increases from eroding the benefit of the personal exemption and the standard deduction. Thus, in addition to adjusting the standard deduction, lawmakers should also consider indexing the state income tax system for inflation as a way to gradually maintain equity in the state tax system.

Digested 2/25/09