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HOUSE COMMITTEE ON FINANCE

TESTIMONY OF THE DEPARTMENT OF TAXATION REGARDING HB 794 RELATING TO TAXATION

TESTIFIER: FREDERICK D. PABLO, DIRECTOR OF TAXATION (OR DESIGNEE)
COMMITTEE: FIN
DATE: FEBRUARY 25, 2011
TIME: 11:00AM

POSITION: SUPPORT

This measure caps the itemized deductions at $50,000 in the case of a joint return with an adjusted gross income of over $300,000; $37,500 in the case of a head of household with adjusted gross income of over $225,000; and $25,000 in the case of an individual with an adjusted gross income of over $150,000. The bill also makes the capital goods excise tax credit nonrefundable until 2016.

The Department supports capping itemized deductions for wealthy individuals in these trying economic times. In addition, the Department supports making the capital goods excise tax credit nonrefundable for a limited period of time to help the State during its current budget situation.

The impact of capping the itemized deductions results in a revenue gain of approximately $44.2 million per year. The revenue impact of making the capital goods excise tax credit nonrefundable is approximately $7.0 million for fiscal year 2012, $2.1 million for fiscal year 2013, $0.7 million for fiscal year 2014, and $0.2 million for fiscal year 2015.

L E G I S L A T I V E

TAXBILLSERVICE

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SUBJECT: INCOME, Limit itemized deductions; suspend refunding of capital goods excise tax credit

BILL NUMBER: HB 794

INTRODUCED BY: Say

BRIEF SUMMARY: Adds a new section to HRS chapter 235 to provide that itemized tax deductions under the state income tax shall not exceed: (1) $50,000 for taxpayers filing a joint return or surviving spouse with adjusted gross income (AGI) of over $300,000; (2) $37,500 for taxpayers filing as a head of household with AGI of over $225,000; (3) $25,000 for taxpayers filing as unmarried individuals with AGI of over $150,000; or (4) $25,000 for taxpayers filing as a married individual filing separately with AGI of over $50,000. This section shall be repealed on January 1, 2016.

Amends HRS section 235-110.7 to provide that the capital goods excise tax credit shall be nonrefundable between January 1, 2011 and December 31, 2014. No refund shall be paid prior to January 1, 2015; provided that the excess credit may be used between January 1, 2012 and December 31, 2015 as a deduction from the taxpayer's net income tax liability.

This act shall apply retroactive to January 1, 2011.

EFFECTIVE DATE: July 1, 2011; applicable to tax years beginning after December 31, 2010

STAFF COMMENTS: At the federal level, taxpayers with high adjusted gross incomes may 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.

It should be noted that a similar measure to limit itemized deductions was vetoed by the governor last year. In her veto message, she stated "it is a defacto tax increase that will adversely hurt certain individuals and businesses at a time when we should be encouraging investment and spending to recharge the economy. The tax increase not only impacts taxpayers, but also disincentivizes activities such as charitable giving and homeownership. Since itemized deductions are allowed for qualifying medical and dental expenses, contributions to qualifying charitable organizations, payment of certain taxes, home mortgage interest, and qualifying job-related expenses, capping the deduction will act to discourage these expenses. Nonprofits and charitable organizations that depend on contributions to serve needy populations are particularly concerned that their ability to raise funds through donations and charitable giving would be adversely affected."

The legislature by Act 178, SLH 2009, initially suspended the capital goods excise tax credit for the calendar year 2009. Currently the capital goods excise tax credit is refundable so that any credit in excess of a taxpayer's income tax liability is refunded to the taxpayer. It appears that this measure proposes that the capital goods excise tax credit shall be made temporarily nonrefundable until January 1, 2015 to address the state's fiscal crisis. However, one has to question the prudence of this strategy as one has to assume that when the moratorium expires, the capital goods excise tax credit will once more become refundable. If it is assumed that the current economic condition continues for some time to come and businesses do not turn a profit because of the slump in the economy, they will probably have very little income tax liability.

If that is the case, when the refundable feature is restored in 2015 there will, no doubt, be an onslaught of claims with the general fund taking a huge hit as claims for the refundable credit are filed. Currently, the tax credit has a $23.5 million cost to the state general fund. Multiply this by the six years of nonrefundable status and the state could be hit with a tab of nearly $120 million.

More importantly, it should be remembered that this credit was adopted to reduce the cost of capital goods which everyone acknowledges are crucial to the creation of jobs. Given the rising unemployment rate as a result of the downturn in the economy and it makes no sense to eliminate the refundable feature of this credit. Unlike many other targeted business tax credits, the capital goods excise tax credit is available to any and every industry. The refundable feature insures that businesses see an immediate return of this tax which supplements their cash flow, keeping them in business during these tough times.

It should be remembered that when this credit was enacted in 1987, it was considered preferable to an exemption from the general excise tax as the use of the capital equipment could be verified that it was to be used in the production of income. Since the credit is claimed by the purchaser, the purchaser was held responsible to prove that the capital equipment was used in the production of income. More importantly, the credit was to provide a return of the tax on an immediate basis so the reduction in the cost of the equipment could be redirected to other costs associated with the creation of jobs. Thus, the delay in realizing the reduction in the cost of the capital equipment defeats the purpose of the credit, that is, to encourage the creation of new employment opportunities, a need that is sorely wanting at this time.

Instead of considering extensions or expansion of other "tax breaks" such as those for high technology research or digital media production, lawmakers should retain the refundable characteristic of the capital goods excise tax credit as it has a much broader application and is just as critical to job creation.

Digested 2/24/11