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To: The Honorable Mele Carroll, Chair  
and Members of the House Committee on Human Services

Date: Tuesday, February 11, 2014  
Time: 9:30 a.m.  
Place: Conference Room 329, State Capitol

From: Frederick D. Pablo, Director  
Department of Taxation

Re: H.B. No. 1835, Relating to Taxation

The Department of Taxation (Department) respectfully opposes H.B. 1835, to require the Department to develop and plan and legislation to convert to a flat income tax. The following comments are for your information and consideration.

H.B. 1835 requires the Department to develop a plan and propose legislation to implement a flat income tax for individual taxpayers by the 2017 taxable year. A flat tax usually involves a low tax rate applied to a wide tax base with few deductions or exemptions, such as the standard deduction, personal exemption, or home mortgage interest deduction. The bill does not set a target rate but does provide that the rate shall be no higher than 3 per cent.

First, the Department notes that implementation of a flat tax system may have the unintended effect of making administration and compliance with Hawaii's income tax law much more complex for taxpayers. This is because even if a flat tax were adopted for Hawaii income tax purposes, Hawaii taxpayers would still need to comply with the federal income tax laws, creating additional compliance issues for most taxpayers.

Also, at this time, Hawaii income tax law substantially conforms to federal income tax law. The similar treatment of most items means that individual compliance to the Hawaii income tax is relatively simple, given that all citizens must complete and file a federal income tax return. Complying with the federal income tax laws also gives taxpayers a head start on compliance with Hawaii income tax laws. Adoption of a flat tax will require abandonment of conformity to the federal income tax and will unnecessarily complicate compliance for Hawaii taxpayers.

Second, a flat tax will likely benefit the higher income earners more than low income

taxpayers as intended. Currently, the top marginal rate for taxpayers with incomes not over \$4,800 per year is 3.2 per cent. Thus, with a tax rate of approximately 3 per cent coupled with lower or no exemptions or deductions, bottom bracket taxpayers will face a tax rate similar to higher income bracket taxpayers, but without the benefit of the current standard deduction and personal exemption.

Under a flat income tax structure, a high income taxpayer who is currently subject to a rate of over 10 per cent would lose the benefit of various deductions, but would only pay 3 per cent. The difference is that the higher income taxpayer has benefited from an approximately 70 per cent reduction in tax rate while the lower income taxpayer has not realized any reduction in tax rate.

Third, the Department is concerned with the proposed implementation date of 2017. Many of Hawaii's taxpayers have relied on the current tax system to plan their futures, often incurring loss carryforwards and excess tax credits they intend to claim in future tax years. Implementation of a flat tax system would require a much longer period. To ensure tax provisions creating carryforwards and credits are sufficiently phased out of the system and to allow currently earned benefits to be fully claimed the implementation period must be greatly extended.

Finally, the Department is concerned with the burden the proposed flat tax project would place on the Department's limited resources. The proposed project would consume significant resources that are not currently available. Moreover, adoption of a flat tax rate would require a serious reconsideration of the Tax System Modernization project which the Department has focused on for the last couple of years.

Thank you for the opportunity to provide testimony.

# TAXBILLSERVICE

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SUBJECT: ADMINISTRATION, Flat income tax

BILL NUMBER: HB 1835

INTRODUCED BY: Mizuno by request

**BRIEF SUMMARY:** Requires the department of taxation shall develop a plan, including proposed legislation, to implement a flat income tax rate of \_\_\_\_% of taxable income. The flat tax shall replace the income tax schedule in HRS section 235-51, and shall dedicate \_\_\_\_% of the income tax revenues to the state's Medicaid program under the department of human services; provided that the flat tax rate shall not exceed 3% of an individual's taxable income.

Directs the department of taxation to work with the department of budget and finance, the department of human services, the legislature, and other departments as necessary, to develop the plan and proposed legislation, repealing tax deductions, exemptions, and credits, the establishment of a special fund for the receipt of income tax revenues for the state's Medicaid program; and establish a task force to recommend the appropriate tax rate to generate income tax revenues comparable to income tax revenues generated within the past five taxable years.

Requires the department of taxation to submit progress reports to the 2015 and 2016 legislature and submit proposed legislation to the 2016 legislature to implement the flat tax by the 2018 tax year.

EFFECTIVE DATE: Upon approval

**STAFF COMMENTS:** This measure would require the department of taxation to replace Hawaii's current income tax with a flat tax of up to 3% of a taxpayer's taxable income and also provide a funding stream to generate revenue to fund the state's Medicaid program. It should be remembered that with any earmarking program, especially those based on a percentage, revenues will fluctuate depending on the amount of revenues received and as such, it is questionable whether there will be a sufficient amount of revenues for funding the state program, in this case the state's Medicaid program. To ensure the viability of the state's Medicaid program, a direct appropriation would be more appropriate.

While the measure would task the department of taxation to develop a plan to replace the current income tax system with a flat tax for implementation by the 2018 tax year, it is questionable whether the department of taxation has the staff, time and resources to undertake this request. Consideration might be given to tasking the next Tax Review Commission with study of this concept.

Digested 2/7/14