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To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Wednesday, February 12, 2014
Time: 2:00 p.m.
Place: Conference Room 308, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. No. 2432, Relating to Taxation

The Department of Taxation (Department) provides the following comments regarding H.B. 2432 for your consideration.

H.B. 2432 excludes from State taxable income amounts received from deferred compensation retirement plans for taxpayers who meet certain income requirements based upon federal Adjusted Gross Income (AGI). The measure applies to taxable years beginning after December 31, 2013.

First, the Department notes that the use of federal AGI is not the best indicator of an individual's economic status. For example, if a taxpayer owns rental real property, due to non-cash expenses such as depreciation, the taxpayer may have negative taxable income. Even though such rental real property may have substantial value, the owner/taxpayer would be an eligible taxpayer under this measure merely because of the negative taxable income effect generated by such the non-cash expenses of rental real property. Alternatively, a taxpayer could be receiving substantial amounts of tax exempt income (i.e., income from municipal bonds), but still qualify for the benefits under this measure since the exempt income would not be included in the taxpayer's federal AGI.

Second, it should be noted that most individuals who are able to fund a deferred compensation retirement plan are unlikely to need financial assistance, since the plans are voluntary.

Third, the Department notes that employee contributions to a deferred compensation retirement plan are structured so that the earnings are excluded from the employee's taxable wages, grow tax-free, and the taxes are then paid upon eventual distribution from the fund. The general notion is that the income is taxed either when earned as a wage or upon distribution. In

the alternative, under the State's hybrid retirement plan, employees pay Hawaii income tax on the amounts contributed to their retirement plan each year and will then receive distributions from the plan tax-free upon retirement. The initial taxation is to compensate for the fact that the distribution will be received tax-free.

Thank you for the opportunity to provide comments.

SUBJECT: INCOME, Exclusion for certain deferred compensation

BILL NUMBER: HB 2432

INTRODUCED BY: Ichiyama, Aquino, Awana, Brower, Cabanilla, Creagan, Cullen, Hashem, Ing, Ito, Kawakami, Kobayashi, Lowen, Luke, McKelvey, Mizuno, Morikawa, Nakashima, Nishimoto, Ohno, Onishi, Say, Takayama, Tokioka, Tsuji, Yamane and 3 Democrats

BRIEF SUMMARY: Adds a new paragraph to HRS section 235-7 to exclude from state income taxation compensation received from deferred compensation retirement plans, including individual retirement accounts, those established under IRC 401(k) or 403(b), or any other retirement plan that defers compensation if a taxpayer's federal adjusted gross income (FAGI) is less than: (1) $30,000 for a taxpayer filing a single return or a married person filing separately; (2) $45,000 for a taxpayer filing as a head of household; and (3) $60,000 for a taxpayer filing a joint return or as a surviving spouse.

EFFECTIVE DATE: Tax years beginning after December 31, 2013

STAFF COMMENTS: Under current law, Hawaii taxpayers may exclude pension income from an employer-funded retirement plan, whether it be $10,000 or $1,000,000 per year. Many of these excludable pension plans were defined benefit plans, which were in vogue a long time ago but, in current economic conditions, became too costly for many private employers to fund. Many employers, as a result, jettisoned the defined benefit plans in favor of defined contribution plans such as plans established under 401(k) of the Code. At the encouragement of the federal tax laws, more and more workers are setting aside resources for their retirement years in the form of 401(k) plans, Simplified Employee Pension Plans (SEP) and Individual Retirement Accounts (IRA). Payments from these deferred compensation types of plans are taxable under both federal and Hawaii law.

This measure would provide that any compensation received from a deferred compensation retirement plan shall not be subject to state income taxation if a taxpayer's FAGI is below the threshold amounts proposed in this measure. This would be in addition to the exclusion already provided for employer-funded pension plan payments.

In simplistic terms, deferred compensation plans were designed to shield income while a taxpayer is employed, and when the taxpayer retires and receives the income the taxpayer would be taxed at that time, but presumably would be in a lower income bracket so that the tax bite is deferred as well as mitigated. Under the proposed measure, such income may escape state income taxation altogether.

It appears that the intent of the measure is to reduce the income tax burden on seniors. If that is the case, we question, as a policy matter, why the tax system should discriminate between different kinds of income (pension income vs. other income) and why the existing system that discriminates between different kinds of pension income (employer funded pensions vs. 401(k) and other kinds of deferred

compensation) should continue to do so. We suggest that in order to promote equality between taxpayers and reduce complexity of the tax return, it is preferable to establish a higher filing threshold (namely, the amount of income you need to make before an income tax return is required to be filed) based on the combination of the standard deduction and personal exemption.

Digested 2/11/14