SUBJECT: INCOME, ESTATE, Conformity to Internal Revenue Code

BILL NUMBER: SB 2821, SD-1

INTRODUCED BY: Senate Committee on Ways and Means

EXECUTIVE SUMMARY: Conforms the Hawaii income tax and estate and generation-skipping transfer taxes to federal changes adopted through December 31, 2017. Decouples from the federal Tax Cuts and Jobs Act in several key areas.


The draft conforms Hawaii law to the Tax Cuts and Jobs Act, Pub. L. No. 115-97, except for several key areas.

**Individual Itemized Deductions:** The draft does not conform to the federal disallowance of itemized deductions, including the mortgage interest deduction limit, the state and local tax deduction limit, and the miscellaneous itemized deduction disallowance.

**Deduction for Passthrough Business Income:** The draft does not conform to the 20% deduction for income from passthrough entities under new IRC section 199A.

**Estate Tax Limits:** The draft freezes the estate and generation-skipping tax exemption amount at 2017 levels.

EFFECTIVE DATE: Upon approval, income tax changes shall apply to taxable years beginning after December 31, 2017 and estate and generation-skipping transfer tax changes shall apply to decedents dying or taxable transfers occurring after December 31, 2017.

STAFF COMMENTS: HRS section 235-2.5 requires the department of taxation to annually submit a measure to maintain state income tax conformity with the federal Internal Revenue Code, and HRS section 236E-4 requires the department to annually submit a measure to maintain state estate and generation-skipping tax conformity with the federal Internal Revenue Code. This is the annual conformity measure sponsored by the department of taxation TAX-01 (18) in compliance with these statutory provisions.

Most states, including ours, conform to federal tax law. That means we generally adopt the federal law provisions that tell us what is income and what we can deduct, so that most of us don’t have to figure out our taxable income many different ways. In fact, our most frequently filed income tax form, the Hawaii N-11, starts off with amounts reported on the federal return, and then adds and subtracts a few things to get Hawaii taxable income.
In a nutshell, the Tax Cuts and Jobs Act did two major things regarding taxation of individuals: it dropped the tax rate for most people, but it limited or wiped out many deductions, making the tax base higher. The tax payable to the federal government is figured by multiplying the two, and the net effect is that people generally can take home more money.

When our state legislature conforms to federal tax changes, we typically adopt the federal provisions regarding what’s taxed and what’s deductible, but typically do not change the tax rates. If our lawmakers stick to that script this year, they will be hurting taxpayers, who will pay tax on a larger tax base but with the same rate as before.

The Tax Reform Act of 1986 also dropped rates and broadened the tax base to accomplish tax reform. Our legislators reacted by enacting Act 239 of 1987, which dropped our tax rates to offer relief from the base broadening.

At the time, our Conference Committee made the following observations, many of which are pertinent to the Tax Cuts and Jobs Act of 2017:

**Tax Reform Act of 1986**

The Federal Tax Reform Act of 1986 is said to be one of the most important pieces of tax legislation enacted by Congress during the past ten years. Certainly, the Act is massive and extensive. For some, the Act is tax simplification in that taxpayers are dropped from the tax rolls due to increased personal exemptions and standard deductions. For others, the Act complicates income taxes.

Some of the major changes to the Income Tax Law contained in the Tax Reform Act of 1986 and adopted in this bill are the repeal of the zero-bracket amounts and the substitution of standard deduction amounts. These amounts in the state income tax law have been increased to maintain a one-third relationship between the federal amounts and the state amounts. This one-third relationship is based on the federal amounts as they will exist in 1988.

... . . .

For the first time since 1965, state income tax brackets and rates are substantially amended. The number of income tax brackets are reduced from the present 12 to 8. The top income tax rate is reduced from 11 per cent to 10 per cent. This reduction in rates is reflected in all brackets. The lower tax rates and reduced number of brackets will help to alleviate bracket creep due to increased income and inflation. Coupled with the food tax credit discussed later, the new rates and brackets will maintain progressivity while providing relief from the income base broadening effects of the Tax Reform Act. In all, about 88 per cent of all single filers, 79 per cent of all joint returns, and 90 per cent of all head of household filers will have a net savings in income taxes.


**Individual Itemized Deductions:** The current draft would add to tax return complexity by requiring taxpayers to claim itemized deductions, and of course keep detailed records supporting
those deductions, only for Hawaii purposes. It would also complicate audits, because the Department would be unable to premise an assessment on a federal adjustment, as is done now, because there would be a large amount of deductions available for state tax purposes only.

Instead, this Committee should consider the same strategy Hawaii adopted in 1987 in response to the Tax Reform Act: let the taxable base be broadened, but reduce rates to an appropriate revenue neutral level. Such a move might even help Hawaii give up the dubious distinction it now holds for having the second highest maximum individual income tax rate in the country.

**Deduction for Passthrough Business Income:** The current draft does not conform to the 20% deduction for income from passthrough entities. The Department has stated that this provision was enacted at the federal level to maintain the current differential in effective tax rates between C-corporations and pass-through entities. The Department reasons that Hawaii has made no change to its corporate tax rates, so there is no change in the relative tax rates to address with such a deduction. However, the Hawaii tax code already has a significant disparity between individual rates, which go up to 11%, and corporate rates, which cap out at 6.4%. Our disparity is worse than that under the federal code. To address this unfairness, it is entirely appropriate for section 199A, IRC, to be incorporated into Hawaii income tax law.

The Foundation has prepared and is attaching a section-by-section analysis of the Tax Cuts and Jobs Act, borrowing extensively from the Joint Explanatory Statement by the Committee on Conference of the U.S. Congress.

Digested 3/13/2018
ANALYSIS OF THE TAX CUTS AND JOBS ACT

In the following analysis, we present an explanation of the provisions in the Tax Cuts and Jobs Act (TCJA) as taken from the Joint Explanatory Statement of the Committee on Conference, the present Hawaii treatment, the proposed action taken in the Bill, and the Foundation’s comments.

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I. INDIVIDUAL TAX PROVISIONS

A. Reduction and Simplification of Individual Income Tax Rates (sec. 1 of the Code)

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   a) Tax Rates

   Tax rate schedules were amended to provide for overall rate reductions. Capital gains rates were not changed but the brackets at which they apply were changed.

   b) Unearned income of children

      (1) Existing Federal Law

      Special rules (generally referred to as the “kiddie tax”) apply to the net unearned income of certain children. Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 19 by the close of the taxable year, or the child is a full-time student under the age of 24, and either of the child’s parents is alive at such time; (2) the child’s unearned income exceeds $2,100 (for 2017); and (3) the child does not file a joint return. The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents. For children above age 17, the kiddie tax applies only to children whose earned income does not exceed one-half of the amount of their support.

      Under these rules, the net unearned income of a child (for 2017, unearned income over $2,100) is taxed at the parents’ tax rates if the parents’ tax rates are higher than the tax rates of the child. The remainder of a child’s taxable income (i.e., earned income, plus unearned income up to $2,100 (for 2017), less the child’s standard deduction) is taxed at the child’s rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts. In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.

      The kiddie tax is calculated by computing the “allocable parental tax.” This involves adding the net unearned income of the child to the parent’s income and then applying the parent’s tax rate. A child’s “net unearned income” is the child’s unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($1,050 for 2017), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.

      The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child’s net unearned income to the parent’s taxable income. If the child has net capital gains or qualified dividends, these items are allocated to the parent’s hypothetical taxable income according to the ratio of net unearned income to the child’s total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child’s net unearned income relative to the aggregate net unearned income of all of the parent’s children subject to the tax.
Generally, a child must file a separate return to report his or her income. In such case, items on the parents’ return are not affected by the child’s income, and the total tax due from the child is the greater of:

1. The sum of (a) the tax payable by the child on the child’s earned income and unearned income up to $2,100 (for 2017), plus (b) the allocable parental tax on the child’s unearned income, or
2. The tax on the child’s income without regard to the kiddie tax provisions.

Under certain circumstances, a parent may elect to report a child’s unearned income on the parent’s return.

(2) Change in Federal Law

The provision simplifies the “kiddie tax” by effectively applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child. Thus, as under present law, taxable income attributable to earned income is taxed according to an unmarried taxpayers’ brackets and rates. Taxable income attributable to net unearned income is taxed according to the brackets applicable to trusts and estates, with respect to both ordinary income and income taxed at preferential rates. Thus, under the provision, the child’s tax is unaffected by the tax situation of the child’s parent or the unearned income of any siblings.

c) Paid preparer due diligence requirement for head of household status

Currently, there are due diligence requirements imposed on paid preparers of federal returns. The requirements now apply to the Earned Income Tax Credit and some other federal credits. The Act directs the Secretary of the Treasury to adopt due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household. A penalty of $500 is imposed for each failure to meet these requirements.

2. Present State Law

State law does not conform to the ordinary income or capital gains rates because state rates are provided in section 235-51, HRS, for both ordinary income and capital gains.

State law, in section 235-7.5, HRS, provides for the taxation of unearned income of minor children as if it were the parent’s income. The methodology is similar to that under federal law prior to the TCJA.

State law presently does not provide for due diligence requirements for paid preparers.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes in ordinary income or capital gains rates.

The bill does not propose any change to the kiddie tax in HRS section 235-7.5.

The bill does not propose to add any due diligence requirements for preparers.
4. **Comments of the Tax Foundation of Hawaii**

We recommend that the Committee consider furthering the federal simplification efforts by adopting most of the federal changes and then enacting rate relief, perhaps with an adjustment to a revenue neutral level, similar to what was done in Hawaii in 1987.

We recommend an adjustment to the kiddie tax provision to conform to the federal changes.

**B. Increase in standard deduction (sec. 63 of the Code)**

1. **Description of Federal Change**

Under present law, an individual who does not elect to itemize deductions may reduce his or her adjusted gross income (“AGI”) by the amount of the applicable standard deduction in arriving at his or her taxable income. The standard deduction is the sum of the basic standard deduction and, if applicable, the additional standard deduction. The basic standard deduction varies depending upon a taxpayer’s filing status. For 2017, the amount of the basic standard deduction is $6,350 for single individuals and married individuals filing separate returns, $9,350 for heads of households, and $12,700 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind. The amount of the standard deduction is indexed annually for inflation.

In the case of a dependent for whom a deduction for a personal exemption is allowed to another taxpayer, the standard deduction may not exceed the greater of (i) $1,050 (in 2017) or the sum of $350 (in 2017) plus the individual’s earned income.

The TCJA amendment temporarily increases the basic standard deduction for individuals across all filing statuses. Under the provision, the amount of the standard deduction is temporarily increased to $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other individuals. The amount of the standard deduction is indexed for inflation using the C-CPI-U for taxable years beginning after December 31, 2018.

The additional standard deduction for the elderly and the blind is not changed by the provision.

2. **Present State Law**

Section 235-2.4(a), HRS, allows for the standard deduction, but in reduced amounts based on filing status.

Under section 235-2.4(a)(1), HRS, state law does not allow for the additional standard deduction for the aged or the blind.

3. **Proposal in SB 2821, SD-1**

The bill does not propose any changes to the standard deduction for Hawaii purposes.
4. Comments of the Tax Foundation of Hawaii

We recommend that the Committee consider furthering the federal simplification efforts by increasing the standard deduction amounts.

C. Repeal of the deduction for personal exemptions (sec. 151 of the Code)

1. Description of Federal Change

   a) Personal Exemptions

   Under present law, in determining taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2017, the amount deductible for each personal exemption is $4,050. This amount is indexed annually for inflation. The personal exemption amount is phased out in the case of an individual with AGI in excess of $313,800 for married taxpayers filing jointly, $287,650 for heads of household, $156,900 for married taxpayers filing separately, and $261,500 for all other filers. In addition, no personal exemption is allowed in the case of a dependent if a deduction is allowed to another taxpayer.

   The TCJA suspends the deduction for personal exemptions.

   b) Withholding rules

   Under present law, the amount of tax required to be withheld by employers from a taxpayer’s wages is based in part on the number of withholding exemptions a taxpayer claims on his Form W-4. An employee is entitled to the following exemptions: (1) an exemption for himself, unless he allowed to be claimed as a dependent of another person; (2) an exemption to which the employee’s spouse would be entitled, if that spouse does not file a Form W-4 for that taxable year claiming an exemption described in (1); (3) an exemption for each individual who is a dependent (but only if the employee’s spouse has not also claimed such a withholding exemption on a Form W-4); (4) additional withholding allowances (taking into account estimated itemized deductions, estimated tax credits, and additional deductions as provided by the Secretary of the Treasury); and (5) a standard deduction allowance.

   The TCJA modifies the withholding rules to consider the elimination of the deduction for personal exemptions.

   c) Filing requirements

   Under present law, an unmarried individual is required to file a tax return for the taxable year if in that year the individual had income which equals or exceeds the exemption amount plus the standard deduction applicable to such individual (i.e., single, head of household, or surviving spouse). An individual entitled to file a joint return is required to do so unless that individual’s gross income, when combined with the individual’s spouse’s gross income for the taxable year, is less than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint return, provided that such individual and his spouse, at the close of the taxable year, had the same household as their home.
The TCJA modifies the filing requirement rules to consider the elimination of the deduction for personal exemptions.

\[d)\] **Trusts and estates**

In lieu of the deduction for personal exemptions, an estate is allowed a deduction of $600. A trust is allowed a deduction of $100; $300 if required to distribute all its income currently; and an amount equal to the personal exemption of an individual in the case of a qualified disability trust.

The TCJA did not change these rules (which are contained in IRC section 642).

2. **Present State Law**

Present state law in section 235-2.3(b)(11), HRS, renders IRC section 151 inoperative.

Section 235-54(a), HRS, allows for a personal exemption amount of $1,144. Nonresident taxpayers are to prorate the exemptions on account of income from sources outside the State.

Section 235-54(b), HRS, allows an estate a deduction of $400; a simple trust $200; and other trusts $80. There is no enhanced deduction for a qualified disability trust.

3. **Proposal in SB 2821, SD-1**

The bill does not propose any changes to the personal exemptions for Hawaii purposes.

4. **Comments of the Tax Foundation of Hawaii**

We recommend that the Committee consider furthering the federal simplification efforts by eliminating the personal exemptions.

D. **Alternative inflation adjustment (sec. 1 of the Code)**

1. **Description of Federal Change**

Under present law, many parameters of the tax system are adjusted for inflation to protect taxpayers from the effects of rising prices. Most of the adjustments are based on annual changes in the level of the Consumer Price Index for All Urban Consumers (“CPI-U”). The CPI-U is an index that measures prices paid by typical urban consumers on a broad range of products, and is developed and published by the Department of Labor.

Among the inflation-indexed tax parameters are the following individual income tax amounts: (1) the regular income tax brackets; (2) the basic standard deduction; (3) the additional standard deduction for aged and blind; (4) the personal exemption amount; (5) the thresholds for the overall limitation on itemized deductions and the personal exemption phase-
out; (6) the phase-in and phase-out thresholds of the earned income credit; (7) IRA contribution limits and deductible amounts; and (8) the saver’s credit.

The TCJA requires the use of the Chained Consumer Price Index for All Urban Consumers (“C-CPI-U”) to adjust tax parameters currently indexed by the CPI-U. The C-CPI-U, like the CPI-U, is a measure of the average change over time in prices paid by urban consumers. It is developed and published by the Department of Labor, but differs from the CPI-U in accounting for the ability of individuals to alter their consumption patterns in response to relative price changes. The C-CPI-U accomplishes this by allowing for consumer substitution between item categories in the market basket of consumer goods and services that make up the index, while the CPI-U only allows for modest substitution within item categories.

2. Present State Law

Present state law does not allow for indexing of any tax bracket or deduction amounts.

3. Proposal in SB 2821, SD-1

The bill does not propose indexing.

4. Comments of the Tax Foundation of Hawaii

We recognize that indexing presents administrative difficulty, and therefore have no recommendation on this issue.

II. TREATMENT OF BUSINESS INCOME OF INDIVIDUALS, TRUSTS, AND ESTATES

A. Deduction for qualified business income (sec. 199A of the Code)

1. Description of Federal Change
   a) Individual income tax rates

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer’s income increases. Separate rate schedules apply based on an individual’s filing status (i.e., single, head of household, married filing jointly, or married filing separately). For 2017, the regular individual income tax rate schedule provides rates of 10, 15, 25, 28, 33, 35, and 39.6 percent.

   b) Partnerships

Partnerships generally are treated for Federal income tax purposes as pass-through entities not subject to tax at the entity level. Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability (based on the partnership’s method of accounting and regardless of whether the income is distributed to the partners). A partner’s deduction for partnership losses is limited to the partner’s adjusted basis in its partnership interest. Losses not
allowed as a result of that limitation generally are carried forward to the next year. A partner’s adjusted basis in the partnership interest generally equals the sum of (1) the partner’s capital contributions to the partnership, (2) the partner’s distributive share of partnership income, and (3) the partner’s share of partnership liabilities, less (1) the partner’s distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any partnership distributions to the partner. Partners generally may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.

State laws of every State provide for limited liability companies (“LLCs”), which are neither partnerships nor corporations under applicable State law, but which are generally treated as partnerships for Federal tax purposes.

Under present law, a publicly traded partnership generally is treated as a corporation for Federal tax purposes. For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.

c) **S corporations**

For Federal income tax purposes, an S corporation generally is not subject to tax at the corporate level. Items of income (including tax-exempt income), gain, loss, deduction, and credit of the S corporation are taken into account by the S corporation shareholders in computing their income tax liabilities (based on the S corporation’s method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder’s deduction for corporate losses is limited to the sum of the shareholder’s adjusted basis in its S corporation stock and the indebtedness of the S corporation to such shareholder. Losses not allowed as a result of that limitation generally are carried forward to the next year. A shareholder’s adjusted basis in the S corporation stock generally equals the sum of (1) the shareholder’s capital contributions to the S corporation and (2) the shareholder’s pro rata share of S corporation income, less (1) the shareholder’s pro rata share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any S corporation distributions to the shareholder.

In general, an S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder’s basis in the stock of the corporation.

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock. Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders of an S corporation.

d) **Sole proprietorships**

Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship is not treated as an entity distinct from its owner for Federal income tax purposes. Rather, the business owner is taxed directly on business income, and files Schedule C (sole
proprietorships generally), Schedule E (rental real estate and royalties), or Schedule F (farms) with his or her individual tax return. Furthermore, transfer of a sole proprietorship is treated as a transfer of each individual asset of the business. Nonetheless, a sole proprietorship is treated as an entity separate from its owner for employment tax purposes, for certain excise taxes, and certain information reporting requirements.

e) Simplified description of the section 199A deduction

In general, the section 199A deduction is 20% of qualified business income that flows up to an owner or shareholder to be reported on that owner’s return. The deduction is designed to give relief to a shareholder because individual tax rates are under the TCJA much higher than the top corporation tax rates. If, therefore, the owner, but for the business income, would be taxable at lower income tax rates (for example, if the owner’s income were mostly capital gain) then the deductible amount may be reduced.

Qualified business income does not include a salary or wage paid to the individual for services to the business. If, for example, a partnership pays a guaranteed payment to an individual manager, or an S corporation pays compensation to a shareholder for services, the guaranteed payment or the wages will not be qualified business income but will be deductible to the entity paying the compensation.

There is a taxable income range provided under the TCJA. For married taxpayers filing jointly, it is $315,000 to $415,000. For individual taxpayers with other filing statuses, the range is $157,500 to $207,500.

Below the bottom end of the taxable income threshold, an individual will be allowed the full 20% deduction.

Above the taxable top end of the income threshold, an individual in a specified service business generally will not be allowed this deduction at all. An individual who is not in a specified service business will not be allowed more than the greater of: 1) 50% of that owner’s share of W-2 wages paid by the business, or 2) the sum of 25% of that owner’s share of W-2 wages paid by the business, and 2.5% of that owner’s share of the undepreciated basis of depreciable fixed assets owned by the business.

For taxpayers with taxable income within the range, the taxpayer will be allowed a phased-in amount determined by a formula that depends on the taxable income, the 20% base amount, and the limitation variables mentioned in the previous paragraph.

A specified service trade or business means any trade or business involving the performance of services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, or which involves the performance of services that consist of investing and investment management trading, or dealing in securities, partnership interests, or commodities. However, architecture and engineering are specifically excluded.
The deduction is taken “below the line,” meaning that it does not reduce AGI, but it does reduce taxable income. It is available to a taxpayer whether or not the taxpayer itemizes deductions.

\[ f \] Treatment of agricultural and horticultural cooperatives

A deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of (a) 20 percent of the cooperative’s taxable income for the taxable year or (b) the greater of 50 percent of the W-2 wages paid by the cooperative with respect to its trade or business or the sum of 25 percent of the W-2 wages of the cooperative with respect to its trade or business plus 2.5 percent of the unadjusted basis immediately after acquisition of qualified property of the cooperative. A specified agricultural or horticultural cooperative is an organization to which subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (c) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

\[ g \] Treatment of trusts and estates

Trusts and estates are eligible for the 20-percent deduction under the provision. Rules similar to the rules under present-law section 199 (as in effect on December 1, 2017) apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital.

2. Present State Law

No comparable provision.

3. Proposal in SB 2821, SD-1

The bill proposes to make this section inapplicable for Hawaii purposes (proposed HRS section 235-2.3(b)(17).

4. Comments of the Tax Foundation of Hawaii

Our top individual tax rate is 11%, second highest in the country, while our top corporate tax rate is 6.4%, which is much more on par with what other states are charging corporations. Right now, our individual income tax law doesn’t even attempt to distinguish between income that comes from a business and income that comes from wages. Because we have chosen to tax business income at a much lower rate if the income is earned in a corporation, we should seriously consider adopting section 199A here in Hawaii to give some relief to the 75% of businesses that are not in corporate form, especially the small businesses.
B. Limitation on losses for taxpayers other than corporations (sec. 461(l) of the Code)

1. Description of Federal Change.

   a) Passive loss rules

   The passive loss rules limit deductions and credits from passive trade or business activities. The passive loss rules apply to individuals, estates and trusts, and closely held corporations. A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer makes a taxable disposition of his entire interest in the passive activity to an unrelated person.

   b) Excess farm loss rules

   A limitation on excess farm losses applies to taxpayers other than C corporations. If a taxpayer other than a C corporation receives an applicable subsidy for the taxable year, the amount of the excess farm loss is not allowed for the taxable year, and is carried forward and treated as a deduction attributable to farming businesses in the next taxable year. An excess farm loss for a taxable year means the excess of aggregate deductions that are attributable to farming businesses over the sum of aggregate gross income or gain attributable to farming businesses plus the threshold amount. The threshold amount is the greater of (1) $300,000 ($150,000 for married individuals filing separately), or (2) for the five-consecutive-year period preceding the taxable year, the excess of the aggregate gross income or gain attributable to the taxpayer’s farming businesses over the aggregate deductions attributable to the taxpayer’s farming businesses.

   c) Description of change

   Excess business losses of a taxpayer other than a corporation are not allowed for the taxable year. Such losses are carried forward and treated as part of the taxpayer’s net operating loss (“NOL”) carryforward in subsequent taxable years. Under the bill, NOL carryovers generally are allowed for a taxable year up to the lesser of the carryover amount or 90 percent (80 percent for taxable years beginning after December 31, 2022) of taxable income determined without regard to the deduction for NOLs.

   An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a taxable year is $250,000 (or twice the otherwise applicable threshold amount in the case of a joint return). The threshold amount is indexed for inflation.
In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner’s distributive share and each S corporation shareholder’s pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or S corporation shareholder. Regulatory authority is provided to apply the provision to any other pass-through entity to the extent necessary to carry out the provision. Regulatory authority is also provided to require any additional reporting as the Secretary determines is appropriate to carry out the purposes of the provision.

The provision applies after the application of the passive loss rules.

For taxable years beginning after December 31, 2017 and before January 1, 2026, the present-law limitation relating to excess farm losses does not apply.

2. Present State Law

State law normally conforms to section 461, IRC.

3. Proposal in SB 2821, SD-1

The bill does not take any specific action on this provision. Federal changes will be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Traditionally, net operating losses have been allowed for State income tax purposes under section 235-7(d), HRS. NOLs must be computed differently for federal and state purposes because of federal-state differences that inevitably exist.

III. SIMPLIFICATION AND REFORM OF FAMILY AND INDIVIDUAL TAX CREDITS

A. Enhancement of child tax credit and new family credit (sec. 24 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

Federal credits are generally inoperative for State income tax purposes under section 235-2.3(b)(1), HRS. This is because state law provides its own set of credits.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment of the credit. Federal changes will not be operative for State income tax purposes.
4. Comments of the Tax Foundation of Hawaii

Traditionally, state law provides its own set of credits so there is no need to conform with federal credit provisions.

B. Credit for the elderly and permanently disabled (sec. 22 of the Code)
   1. Description of Federal Change – Omitted

   Federal credits are generally inoperative for State income tax purposes under section 235-2.3(b)(1), HRS. This is because state law provides its own set of credits.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state treatment of the credit. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

   Traditionally, state law provides its own set of credits so there is no need to conform with federal credit provisions.

C. Consolidation and modification of education savings rules (secs. 529 and 530 of the Code)
   1. Description of Federal Change
      a) Coverdell education savings accounts

   A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary. Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

   Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn. However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (i.e., the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.

   Tax-free (and free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell
education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include qualified elementary and secondary expenses and qualified higher education expenses. Such qualified education expenses generally include only out-of-pocket expenses. They do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income.

The term qualified elementary and secondary school expenses, means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in section 170(e)(6)(F)(i)) or internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary’s family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

The term qualified higher education expenses includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.

b) Section 529 qualified tuition programs

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a “prepaid tuition program”). Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs. In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition
program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a “savings account program”). Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary’s higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are typically made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”) whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

\[c) \quad \text{Qualified higher education expenses}\]

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the Code, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time. Qualified higher education expenses include the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used primarily by the beneficiary during any of the years a beneficiary is enrolled at an eligible institution.

\[d) \quad \text{Contributions to qualified tuition programs}\]

Contributions to a qualified tuition program must be made in cash. Section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary’s qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not tax deductible for Federal income tax purposes, although they may be deductible for State income tax purposes.
Amounts in the account accumulate on a tax-free basis (*i.e.*, income on accounts in the plan is not subject to current income tax).

A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to direct (directly or indirectly) the investment of any contributions (or earnings thereon) more than two times in any calendar year, and must provide separate accounting for each designated beneficiary. A qualified tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan.

e) Description of Change

Coverdell plans and education savings accounts are consolidated. No new contributions are permitted into Coverdell savings accounts after December 31, 2017. However, rollovers of account balances from one Coverdell education savings account to another pre-existing Coverdell education savings account benefiting another beneficiary remain permitted after this date. Additionally, the provision allows section 529 plans to receive rollover contributions from Coverdell education savings accounts.

The provision modifies section 529 plans to allow such plans to distribute not more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private or religious elementary or secondary school. This limitation applies on a per-student basis, rather than a per-account basis. Thus, under the provision, although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of $10,000 in distributions free of tax, regardless of whether the funds are distributed from multiple accounts. Any excess distributions received by the individual would be treated as a distribution subject to tax under the general rules of section 529.

The provision also modifies section 529 plans to allow such plan distributions to be used for certain expenses, including books, supplies, and equipment, required for attendance in a registered apprenticeship program. Registered apprenticeship programs are apprenticeship programs registered and certified with the Secretary of Labor.

The provision also modifies the definition of higher education expenses to include certain expenses incurred in connection with a homeschool. Those expenses are (1) curriculum and curricular materials; (2) books or other instructional materials; (3) online educational materials; tuition for tutoring or educational classes outside of the home (but only if the tutor or instructor is not related to the student); (5) dual enrollment in an institution of higher education; and (6) educational therapies for students with disabilities.

Finally, the provision specifies that nothing in this section shall prevent an unborn child from qualifying as a designated beneficiary. For these purposes, an unborn child means a child *in utero*, and the term child *in utero* means a member of the species *homo sapiens*, at any stage of development, who is carried in the womb.

2. Present State Law
State law generally conforms to the Coverdell education savings account provisions in section 530, IRC, under section 235-2.4(ff), HRS.

State law generally conforms to section 529, IRC, under section 235-2.4(dd), HRS, except for IRC sections 529(c)(6) (imposing a penalty tax for a nonqualified distribution) and 529(e)(3)(A)(iii) (relating to certain software as a qualified educational expense).

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment of such savings accounts, meaning that federal changes would be adopted.

4. Comments of the Tax Foundation of Hawaii

Traditionally, state law does not conform to penalty provisions but otherwise conforms to qualified plan provisions and other provisions relating to qualified savings accounts. It would make sense to conform to the federal changes while making the penalty provision inoperative as it is now.

D. Reforms to discharge of certain student loan indebtedness (sec. 108 of the Code)

1. Description of Federal Change

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student’s working for a certain period of time in certain professions for any of a broad class of employers.

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation.

In addition, an individual’s gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan
must be contingent on the student working in an occupation or area with unmet needs and such work must be performed for, or under the direction of, a tax-exempt charitable organization or a governmental entity.

Finally, an individual’s gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program, certain State loan repayment programs, or any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the State).

The TCJA modifies the exclusion of student loan discharges from gross income, by including within the exclusion certain discharges on account of death or disability. Loans eligible for the exclusion under the provision are loans made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation, or (5) private education loans (for this purpose, private education loan is defined in section 140(7) of the Consumer Protection Act).

Under the provision, the discharge of a loan as described above is excluded from gross income if the discharge was pursuant to the death or total and permanent disability of the student.

2. Present State Law

State law generally conforms to IRC section 108, with an exception not here relevant, under section 235-2.4(e), HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in State treatment, meaning that State law would conform to the federal changes.

4. Comments of the Tax Foundation of Hawaii

We do not recommend State treatment different from that proposed in the Senate bill.

E. Rollovers between qualified tuition programs and qualified ABLE programs (secs. 529 and 529A of the Code)

1. Description of Federal Change

   a) Qualified ABLE programs

      (1) Background

The Code provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs. A qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLE program must meet the following conditions: (1) under the provisions of the program,
contributions may be made to an account (an “ABLE account”), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLE account; and (3) the program must meet certain other requirements discussed below. A qualified ABLE program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations.

A designated beneficiary of an ABLE account is the owner of the ABLE account. A designated beneficiary must be an eligible individual (defined below) who established the ABLE account and who is designated at the commencement of participation in the qualified ABLE program as the beneficiary of amounts paid (or to be paid) into and from the program.

Contributions to an ABLE account must be made in cash and are not deductible for Federal income tax purposes. Except in the case of a rollover contribution from another ABLE account, an ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under section 2503(b) of the Code (the annual gift tax exemption). For 2017, this is $14,000. Additionally, a qualified ABLE program must provide adequate safeguards to ensure that ABLE account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLE program. Amounts in the account accumulate on a tax-deferred basis (i.e., income on accounts under the program is not subject to current income tax).

A qualified ABLE program may permit a designated beneficiary to direct (directly or indirectly) the investment of any contributions (or earnings thereon) no more than two times in any calendar year and must provide separate accounting for each designated beneficiary. A qualified ABLE program may not allow any interest in the program (or any portion thereof) to be used as security for a loan.

Distributions from an ABLE account are generally includible in the distributee’s income to the extent consisting of earnings on the account. Distributions from an ABLE account are excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the designated beneficiary during the taxable year. If a distribution from an ABLE account exceeds the qualified disability expenses of the designated beneficiary, a pro rata portion of the distribution is excludable from income. The portion of any distribution that is includible in income is subject to an additional 10-percent tax unless the distribution is made after the death of the beneficiary. Amounts in an ABLE account may be rolled over without income tax liability to another ABLE account for the same beneficiary or another ABLE account for the designated beneficiary’s brother, sister, stepbrother or stepsister who is also an eligible individual.

Except in the case of an ABLE account established in a different ABLE program for purposes of transferring ABLE accounts, no more than one ABLE account may be established by a designated beneficiary. Thus, once an ABLE account has been established by a designated beneficiary, no account subsequently established by such beneficiary shall be treated as an ABLE account.

A contribution to an ABLE account is treated as a completed gift of a present interest to the designated beneficiary of the account. Such contributions qualify for the per-donee annual
gift tax exclusion ($14,000 for 2017) and, to the extent of such exclusion, are exempt from the generation skipping transfer (“GST”) tax. A distribution from an ABLE account generally is not subject to gift tax or GST tax.

(2) Eligible individuals

As described above, a qualified ABLE program may provide for the establishment of ABLE accounts only if those accounts are established and owned by an eligible individual, such owner referred to as a designated beneficiary. For these purposes, an eligible individual is an individual either (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to Social Security Disability Insurance benefits or SSI benefits based on blindness or disability, and such blindness or disability occurred before the individual attained age 26.

A disability certification means a certification to the satisfaction of the Secretary, made by the eligible individual or the parent or guardian of the eligible individual, that the individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind (within the meaning of section 1614(a)(2) of the Social Security Act). Such blindness or disability must have occurred before the date the individual attained age 26. Such certification must include a copy of the diagnosis of the individual’s impairment and be signed by a licensed physician.

(3) Qualified disability expenses

As described above, the earnings on distributions from an ABLE account are excluded from income only to the extent total distributions do not exceed the qualified disability expenses of the designated beneficiary. For this purpose, qualified disability expenses are any expenses related to the eligible individual’s blindness or disability which are made for the benefit of the designated beneficiary. Such expenses include the following expenses: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary under regulations and consistent with the purposes of section 529A.

(4) Transfer to State

In the event that the designated beneficiary dies, subject to any outstanding payments due for qualified disability expenses incurred by the designated beneficiary, all amounts remaining in the deceased designated beneficiary’s ABLE account not in excess of the amount equal to the total medical assistance paid such individual under any State Medicaid plan established under title XIX of the Social Security Act shall be distributed to such State upon filing of a claim for payment by such State. Such repaid amounts shall be net of any premiums paid from the account or by or on behalf of the beneficiary to the State’s Medicaid Buy-In program.

(5) Treatment of ABLE accounts under Federal programs

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Any amounts in an ABLE account, and any distribution for qualified disability expenses, shall be disregarded for purposes of determining eligibility to receive, or the amount of, any assistance or benefit authorized by any Federal means-tested program. However, in the case of the SSI program, a distribution for housing expenses is not disregarded, nor are amounts in an ABLE account in excess of $100,000. In the case that an individual’s ABLE account balance exceeds $100,000, such individual’s SSI benefits shall not be terminated, but instead shall be suspended until such time as the individual’s resources fall below $100,000. However, such suspension shall not apply for purposes of Medicaid eligibility.

b) Changed Treatment

The TCJA allows for amounts from qualified tuition programs (also known as 529 accounts) to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account, or a member of such designated beneficiary's family. Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a taxable year. Any amount rolled over that is in excess of this limitation shall be includible in the gross income of the distributee in a manner provided by section 72.

2. Present State Law

State law generally conforms to the ABLE account provisions in section 529A, IRC, under section 235-2.4(ee), HRS, except for section 529A(c)(3) (with respect to additional tax for distributions not used for disability expenses).

State law generally conforms to section 529, IRC, under section 235-2.4(dd), HRS, except for IRC sections 529(c)(6) (imposing a penalty tax for a nonqualified distribution) and 529(c)(3)(A)(iii) (relating to certain software as a qualified educational expense).

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment, meaning that federal changes would be adopted.

4. Comments of the Tax Foundation of Hawaii

Traditionally, state law does not conform to penalty provisions but otherwise conforms to qualified plan provisions and other provisions relating to qualified savings accounts. It would make sense to conform to the federal changes while making the penalty provision inoperative as it is now.

IV. SIMPLIFICATION AND REFORM OF DEDUCTIONS AND EXCLUSIONS

A. Repeal of overall limitation on itemized deductions (sec. 68 of the Code)

1. Description of Federal Change

The total amount of most otherwise allowable itemized deductions (other than the deductions for medical expenses, investment interest and casualty, theft or gambling losses) is
limited for certain upper-income taxpayers. All other limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced by three percent of the amount by which the taxpayer’s adjusted gross income exceeds a threshold amount.

For 2017, the threshold amounts are $261,500 for single taxpayers, $287,650 for heads of household, $313,800 for married couples filing jointly, and $156,900 for married taxpayers filing separately. These threshold amounts are indexed for inflation. The otherwise allowable itemized deductions may not be reduced by more than 80 percent by reason of the overall limit on itemized deductions.

The TCJA suspends the overall limitation on itemized deductions.

2. Present State Law

State law conforms to the overall limitation on itemized deductions in section 68, IRC, under section 235-2.4(b), HRS, except that the thresholds are those that were in force in the IRC for calendar year 2009 and are not indexed for inflation.

3. Proposal in SB 2821, SD-1

The bill proposes to decouple from the federal changes, according to proposed section 235-2.4(c), HRS, meaning that State law would impose an overall limitation on itemized deductions even if federal law does not.

4. Comments of the Tax Foundation of Hawaii

The federal law proposes to remove the limitation on itemized deductions given that all or most of the itemized deductions are going to be disallowed up front. If the federal approach to tax simplification is followed, conformity to federal law would be preferable.

B. Modification of deduction for home mortgage interest (sec. 163(h) of the Code)

1. Description of Federal Change
   a) Background

   As a general matter, personal interest is not deductible. Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations. Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer’s principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

   b) Acquisition indebtedness
Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and which secures the residence. The maximum amount treated as acquisition indebtedness is $1 million ($500,000 in the case of a married person filing a separate return).

Acquisition indebtedness also includes indebtedness from the refinancing of other acquisition indebtedness but only to the extent of the amount (and term) of the refinanced indebtedness. Thus, for example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to $150,000, the taxpayer’s acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to substantially improve the residence).

Interest on acquisition indebtedness is allowable in computing alternative minimum taxable income. However, in the case of a second residence, the acquisition indebtedness may only be incurred with respect to a house, apartment, condominium, or a mobile home that is not used on a transient basis.

c) Home equity indebtedness

Home equity indebtedness is indebtedness (other than acquisition indebtedness) secured by a qualified residence.

The amount of home equity indebtedness may not exceed $100,000 ($50,000 in the case of a married individual filing a separate return) and may not exceed the fair market value of the residence reduced by the acquisition indebtedness.

Interest on home equity indebtedness is not deductible in computing alternative minimum taxable income.

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used. For example, personal expenditures may include health costs and education expenses for the taxpayer’s family members or any other personal expenses such as vacations, furniture, or automobiles. A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer in a lump sum payment (e.g., a traditional mortgage), a series of payments (e.g., a reverse mortgage), or the lender may extend the borrower a line of credit up to a fixed limit over the term of the loan (e.g., a home equity line of credit).

Thus, the aggregate limitation on the total amount of a taxpayer’s acquisition indebtedness and home equity indebtedness with respect to a taxpayer’s principal residence and a second residence that may give rise to deductible interest is $1,100,000 ($550,000, for married persons filing a separate return).

d) Treatment under the TCJA

A taxpayer may treat no more than $750,000 as acquisition indebtedness ($375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred
before December 15, 2017 this limitation is $1,000,000 ($500,000 in the case of married taxpayers filing separately).

Additionally, the TCJA suspends the deduction for interest on home equity indebtedness. Thus, for taxable years beginning after December 31, 2017, a taxpayer may not claim a deduction for interest on home equity indebtedness.

2. Present State Law

State law conforms to the deduction for interest in section 163, IRC. under section 235-2.4(h), HRS, except for the following provisions: (1) section 163(d)(4)(B) (defining net investment income to exclude dividends), (2) section 163(e)(5)(F) (suspension of applicable high-yield discount obligation (AHYDO) rules), and (3) section 163(i)(1) as it applies to debt instruments issued after January 1, 2010, (defining AHYDO).

3. Proposal in SB 2821, SD-1

The bill proposes to decouple from the federal changes, according to proposed section 235-2.4(i)(4), HRS, meaning that State law would still allow a deduction for mortgage interest, both acquisition debt and home equity debt, to the extent it was allowable in 2017.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal base-broadening changes and reducing the overall tax rate.

C. Modification of deduction for taxes not paid or accrued in a trade or business (sec. 164 of the Code)

1. Description of Federal Change

Individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer’s trade or business. These taxes are: (i) State and local real and foreign property taxes; (ii) State and local personal property taxes; (iii) State, local, and foreign income, war profits, and excess profits taxes. At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.

Property taxes may be allowed as a deduction in computing adjusted gross income if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business.

Individuals also are permitted a deduction for Federal and State generation skipping transfer tax (“GST tax”) imposed on certain income distributions that are included in the gross income of the distributee.
In determining a taxpayer’s alternative minimum taxable income, no itemized deduction for property, income, or sales tax is allowed.

The TCJA provides that in the case of an individual, as a general matter, State, local, and foreign property taxes and State and local sales taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business, or an activity described in section 212 (relating to expenses for the production of income). Thus, the provision allows only those deductions for State, local, and foreign property taxes, and sales taxes, that are presently deductible in computing income on an individual’s Schedule C, Schedule E, or Schedule F on such individual’s tax return. Thus, for instance, in the case of property taxes, an individual may deduct such items only if these taxes were imposed on business assets (such as residential rental property).

Under the provision, in the case of an individual, State and local income, war profits, and excess profits taxes are not allowable as a deduction.

The TCJA contains an exception to the above-stated rule. Under the provision a taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for the aggregate of (i) State and local property taxes not paid or accrued in carrying on a trade or business, or an activity described in section 212, and (ii) State and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the taxable year. Foreign real property taxes may not be deducted under this exception.

The TCJA also provides that, in the case of an amount paid in a taxable year beginning before January 1, 2018, with respect to a State or local income tax imposed for a taxable year beginning after December 31, 2017, the payment shall be treated as paid on the last day of the taxable year for which such tax is so imposed for purposes of applying the provision limiting the dollar amount of the deduction. Thus, under the provision, an individual may not claim an itemized deduction in 2017 on a pre-payment of income tax for a future taxable year in order to avoid the dollar limitation applicable for taxable years beginning after 2017.

2. Present State Law

State law conforms to the deduction for taxes in section 164, IRC, under section 235-2.4(i), HRS, except that: (1) taxpayers are not allowed the option of deducting state and local sales taxes; (2) no deduction at all is supposed to be allowed to corporate taxpayers, but the Department has ruled in Dept. of Taxation Announcement No. 2011-20 that corporate taxpayers may deduct taxes anyway under section 162 relating to business expenses; (3) no deduction is allowed to individual taxpayers whose federal AGI meets or exceeds certain thresholds (single or married filing separately, $100,000; head of household, $150,000; married filing jointly, $200,000); and (4) no deduction is allowed for any amounts for which the credit for residents who have paid out-of-state taxes (section 235-55, HRS) has been claimed.

3. Proposal in SB 2821, SD-1

The bill proposes to decouple from the federal changes, according to proposed section 235-2.4(j)(1), HRS, meaning that State law would still allow a deduction for state and local
taxes, and in addition State law would now allow taxpayers the option of deducting state and local sales taxes.

4. **Comments of the Tax Foundation of Hawaii**

We generally recommend conforming to the federal base-broadening changes and reducing the overall tax rate.

**D. Repeal of deduction for personal casualty and theft losses (sec. 165 of the Code)**

1. **Description of Federal Change**

A taxpayer may generally claim a deduction for any loss sustained during the taxable year, not compensated by insurance or otherwise. For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer’s adjusted gross income.

Under the TCJA, a taxpayer may claim a personal casualty loss (subject to the limitations described above) only if such loss was attributable to a disaster declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

2. **Present State Law**

State law conforms to the deduction for losses in section 165, IRC. under section 235-2.4(j), HRS, except that: (1) a personal casualty loss is allowed only to the extent the loss exceeds $100, notwithstanding section 165(h)(1), IRC (which now happens to provide the same limitation); (2) section 165(h)(3)(A) and (B) (both of which relate to special rules for personal casualty gains and losses in federally declared disasters), IRC (note that the references are now obsolete, because the current Code provisions don’t relate to federally declared disasters); and (3) the loss deduction also applies to losses sustained from the sale of stocks or other interests issued through the exercise of the stock options or warrants granted by a qualified high technology business as defined in section 235-7.3, HRS.

3. **Proposal in SB 2821, SD-1**

The bill proposes to decouple from the federal changes, according to proposed section 235-2.4(k)(3), HRS, meaning that State law would still allow a deduction for personal casualty losses.

4. **Comments of the Tax Foundation of Hawaii**

We generally recommend conforming to the federal base-broadening changes and reducing the overall tax rate.
In any event, the references in the current law to sections 165(h)(3)(A) and (B) should be corrected to point to the proper sections in the IRC.

E. Limitation on wagering losses (sec. 165 of the Code)

1. Description of Federal Change

Losses sustained during the taxable year on wagering transactions are allowed as a deduction only to the extent of the gains during the taxable year from such transactions.

The TCJA clarifies the scope of “losses from wagering transactions” as that term is used in section 165(d). Under the provision, this term includes any deduction otherwise allowable under chapter 1 of the Code incurred in carrying on any wagering transaction.

The provision is intended to clarify that the limitation on losses from wagering transactions applies not only to the actual costs of wagers incurred by an individual, but to other expenses incurred by the individual in connection with the conduct of that individual’s gambling activity. The provision clarifies, for instance, that an individual’s otherwise deductible expenses in traveling to or from a casino are subject to the limitation under section 165(d).

2. Present State Law

State law conforms to the deduction for losses in section 165, IRC, with exceptions as stated in the previous section.

3. Proposal in SB 2821, SD-1

The bill does not propose any change in conformity to section 165(d), IRC, meaning that State law would still conform to federal law in this regard.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal base-broadening changes and reducing the overall tax rate.

F. Modifications to the deduction for charitable contributions (sec. 170 of the Code)

1. Description of Federal Change

The Internal Revenue Code allows taxpayers to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities, Federal, State, local, and Indian tribal governments, and certain other organizations.

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (i.e., an organization or entity described in section 170(c)). Second, the transfer
must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor’s entire interest in the contributed property (i.e., not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year. Fourth, the transfer must be of money or property — contributions of services are not deductible. Finally, the transfer must be substantiated and in the proper form. As discussed below, special rules limit the deductibility of a taxpayer’s charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

\[a) \quad \text{Percentage limits on charitable contributions}\]

(1) Individual taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual’s contribution base. The contribution base is the taxpayer’s adjusted gross income (“AGI”) for a taxable year, disregarding any net operating loss carryback to the year under section 172. In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer’s contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer’s contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

Contributions of appreciated capital gain property to public charities and other organizations described in section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer’s contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer’s contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30 percent limitation.

Finally, contributions that are for the use of (not to) the donee charity get less favorable percentage limits. Contributions of capital gain property for the use of public charities and other organizations described in section 170(b)(1)(A) also are limited to 20 percent of the taxpayer’s contribution base. Property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization. Charitable contributions
of income interests (where deductible) also generally are treated as contributions for the use of
the donee organization.

(2) Corporate taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the
corporation’s taxable income for the year. For this purpose, taxable income is determined
without regard to: (1) the charitable contributions deduction; (2) any net operating loss
carryback to the taxable year; (3) deductions for dividends received; (4) deductions for
 dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to
the taxable year.

b) College athletic seating rights.

In general, where a taxpayer receives or expects to receive a substantial return benefit
for a payment to charity, the payment is not deductible as a charitable contribution. However,
special rules apply to certain payments to institutions of higher education in exchange for which
the payor receives the right to purchase tickets or seating at an athletic event. Specifically, the
payor may treat 80 percent of a payment as a charitable contribution where: (1) the amount is
paid to or for the benefit of an institution of higher education (as defined in section 3304(f))
described in section (b)(1)(A)(ii) (generally, a school with a regular faculty and curriculum and
meeting certain other requirements), and (2) such amount would be allowable as a charitable
deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the
payment the right to purchase tickets for seating at an athletic event in an athletic stadium of
such institution.

c) Substantiation and other formal requirements

A donor who claims a deduction for a charitable contribution must maintain reliable
written records regarding the contribution, regardless of the value or amount of such
contribution. In the case of a charitable contribution of money, regardless of the amount,
applicable recordkeeping requirements are satisfied only if the donor maintains as a record of
the contribution a bank record or a written communication from the donee showing the name of
the donee organization, the date of the contribution, and the amount of the
contribution. In such
cases, the recordkeeping requirements may not be satisfied by maintaining other written
records.

No charitable contribution deduction is allowed for a separate contribution of $250 or
more unless the donor obtains a contemporaneous written acknowledgement of the contribution
from the charity indicating whether the charity provided any good or service (and an estimate of
the value of any such good or service) to the taxpayer in consideration for the contribution.

In addition, any charity receiving a contribution exceeding $75 made partly as a gift and
partly as consideration for goods or services furnished by the charity (a “quid pro quo”
contribution) is required to inform the contributor in writing of an estimate of the value of the
goods or services furnished by the charity and that only the portion exceeding the value of the
goods or services is deductible as a charitable contribution.
If the total charitable deduction claimed for noncash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer’s return or the deduction is not allowed.

**d) Description of federal changes**

The provision makes the following modifications to the present law charitable deduction:

(1) **Increased percentage limit for contributions of cash to public charities**

The TCJA increases the income-based percentage limit described in section 170(b)(1)(A) for certain charitable contributions by an individual taxpayer of cash to public charities and certain other organizations from 50 percent to 60 percent.

(2) **Denial of charitable deduction for college athletic event seating rights**

The TCJA amends section 170(l) to provide that no charitable deduction shall be allowed for any amount described in paragraph 170(l)(2), generally, a payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event, as described in greater detail above.

(3) **Repeal of substantiation exception for certain contributions reported by the donee organization**

The provision repeals the section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement.

(4) **Effective date**

The provisions that increase the charitable contribution percentage limit and deny a deduction for stadium seating payments are effective for contributions made in taxable years beginning after December 31, 2017. The provision that repeals the substantiation exception for certain contributions reported by the donee organization is effective for contributions made in taxable years beginning after December 31, 2016.

2. **Present State Law**

State law conforms to the deduction for charitable contributions in section 170, IRC.

3. **Proposal in SB 2821, SD-1**

The bill does not propose any change in conformity to section 170, IRC, meaning that State law would still conform to federal law in this regard.
4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

G. Repeal of Certain Miscellaneous Itemized Deductions Subject to the Two-Percent Floor (secs. 62, 67 and 212 of the Code)

1. Description of Federal Change

Individuals may claim itemized deductions for certain miscellaneous expenses. Certain of these expenses are not deductible unless, in aggregate, they exceed two percent of the taxpayer’s adjusted gross income (“AGI”). The deductions described below are subject to the aggregate two-percent floor.

a) Expenses for the production or collection of income

Individuals may deduct all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income.

Present law and IRS guidance provide examples of items that may be deducted under this provision. This non-exhaustive list includes:

- Appraisal fees for a casualty loss or charitable contribution;
- Casualty and theft losses from property used in performing services as an employee;
- Clerical help and office rent in caring for investments;
- Depreciation on home computers used for investments;
- Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust;
- Fees to collect interest and dividends;
- Hobby expenses, but generally not more than hobby income;
- Indirect miscellaneous deductions from pass-through entities;
- Investment fees and expenses;
- Loss on deposits in an insolvent or bankrupt financial institution;
- Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed;
- Repayments of income;
- Safe deposit box rental fees, except for storing jewelry and other personal effects;
- Service charges on dividend reinvestment plans; and
- Trustee’s fees for an IRA, if separately billed and paid.
b) **Tax preparation expenses**

For regular income tax purposes, individuals are allowed an itemized deduction for expenses for the production of income. These expenses are defined as ordinary and necessary expenses paid or incurred in a taxable year: (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, collection, or refund of any tax.

c) **Unreimbursed expenses attributable to the trade or business of being an employee**

In general, unreimbursed business expenses incurred by an employee are deductible, but only as an itemized deduction and only to the extent the expenses exceed two percent of adjusted gross income.

Present law and IRS guidance provide examples of items that may be deducted under this provision. This non-exhaustive list includes:

- Business bad debt of an employee;
- Business liability insurance premiums;
- Damages paid to a former employer for breach of an employment contract;
- Depreciation on a computer a taxpayer’s employer requires him to use in his work;
- Dues to a chamber of commerce if membership helps the taxpayer perform his job;
- Dues to professional societies;
- Educator expenses (under a special provision, these expenses are deductible “above the line” up to $250);
- Home office or part of a taxpayer’s home used regularly and exclusively in the taxpayer’s work;
- Job search expenses in the taxpayer’s present occupation;
- Laboratory breakage fees;
- Legal fees related to the taxpayer’s job;
- Licenses and regulatory fees;
- Malpractice insurance premiums;
- Medical examinations required by an employer;
- Occupational taxes;
- Passport fees for a business trip;
- Repayment of an income aid payment received under an employer’s plan;
- Research expenses of a college professor;
- Rural mail carriers’ vehicle expenses;
• Subscriptions to professional journals and trade magazines related to the taxpayer’s work;
• Tools and supplies used in the taxpayer’s work;
• Purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer’s work;
• Union dues and expenses;
• Work clothes and uniforms if required and not suitable for everyday use; and
• Work-related education.

d) Other miscellaneous itemized deductions subject to the two-percent floor

Other miscellaneous itemized deductions subject to the two-percent floor include:

• Repayments of income received under a claim of right (only subject to the two-percent floor if less than $3,000);
• Repayments of Social Security benefits; and
• The share of deductible investment expenses from pass-through entities.

e) Description of change

The TCJA suspends all miscellaneous itemized deductions that are subject to the two-percent floor under present law. Thus, under the provision, taxpayers may not claim the above-listed items as itemized deductions for the taxable years to which the suspension applies.

2. Present State Law

State law conforms to sections 62, 67, and 212, IRC.

3. Proposal in SB 2821, SD-1

The bill proposes to decouple from the suspension of the allowance of miscellaneous itemized deductions, meaning that State law would still allow all of the above deductions subject to the 2% AGI floor, even though federal law does not allow those deductions.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

H. Deduction for medical expenses (sec. 213 of the Code)
1. Description of Federal Change
Individuals may claim an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 10 percent of adjusted gross income. For taxable years beginning before January 1, 2017, the 10-percent threshold is reduced to 7.5 percent in the case of taxpayers who have attained the age of 65 before the close of the taxable year. In the case of married taxpayers, the 7.5 percent threshold applies if either spouse has obtained the age of 65 before the close of the taxable year. For these taxpayers, during these years, the threshold is 10 percent for alternative minimum tax (AMT) purposes.

The TCJA provides that, for taxable years beginning after December 31, 2016 and ending before January 1, 2019, the threshold for deducting medical expenses shall be 7.5 percent for all taxpayers. For these years, this threshold applies for purposes of the AMT in addition to the regular tax.

2. Present State Law

State law conforms to section 213, IRC.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to medical expense deductions, meaning that State law would conform to the federal changes.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

I. Repeal of deduction for alimony payments and corresponding inclusion in gross income (secs. 61, 71, and 215 of the Code)

1. Description of Federal Change

Under present law, alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the recipient spouse. Child support payments are not treated as alimony.

Under the TCJA, alimony and separate maintenance payments are not deductible by the payor spouse. The TCJA repeals the Code provisions that specify that alimony and separate maintenance payments are included in income. Thus, the intent of the provision is to follow the rule of the United States Supreme Court’s holding in Gould v. Gould, in which the Court held that such payments are not income to the recipient. Income used for alimony payments is taxed at the rates applicable to the payor spouse rather than the recipient spouse.

The treatment of child support is not changed.

Effective date.—The provision is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or
before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification.

2. Present State Law

State law conforms to the deduction for alimony and separate maintenance payments in section 61, 71, and 215, IRC.

3. Proposal in SB 2821, SD-1

The bill does not propose any change in conformity to sections 61, 71, and 215, IRC, meaning that State law would still conform to federal law in this regard.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

J. Repeal of deduction for moving expenses (sec. 217 of the Code)

1. Description of Federal Change

Individuals are permitted an above-the-line deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work. Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer’s previous residence and the taxpayer’s status as a full-time employee in the new location.

Special rules apply in the case of a member of the Armed Forces of the United States. In the case of any such individual who is on active duty, who moves pursuant to a military order and incident to a permanent change of station, the limitations related to distance from the taxpayer’s previous residence and status as a full-time employee in the new location do not apply. Additionally, any moving and storage expenses which are furnished in kind to such an individual, spouse, or dependents, or if such expenses are reimbursed or an allowance for such expenses is provided, such amounts are excluded from gross income. Rules also apply to exclude amounts furnished to the spouse and dependents of such an individual in the event that such individuals move to a location other than to where the member of the Armed Forces is moving.

Present law provides income exclusions for various benefits provided to members of the Armed Forces.

The TCJA generally suspends the deduction for moving expenses. However, during that suspension period, the provision retains the deduction for moving expenses and the rules providing for exclusions of amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) for members of the Armed Forces (or their
spouse or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station.

2. Present State Law

State law conforms to the deduction for moving expenses in section 217, IRC.

3. Proposal in SB 2821, SD-1

The bill proposes to decouple from the suspension of section 217, IRC, in proposed section 235-2.4(p), HRS, meaning that State law would still allow moving expenses to be deductible even if federal law did not.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

K. Suspension of exclusion for qualified bicycle commuting reimbursement (sec. 132(f) of the Code)

1. Description of Federal Change

Qualified bicycle commuting reimbursements of up to $20 per qualifying bicycle commuting month are excludible from an employee’s gross income. A qualifying bicycle commuting month is any month during which the employee regularly uses the bicycle for a substantial portion of travel to a place of employment and during which the employee does not receive transportation in a commuter highway vehicle, a transit pass, or qualified parking from an employer.

Qualified reimbursements are any amount received from an employer during a 15-month period beginning with the first day of the calendar year as payment for reasonable expenses during a calendar year. Reasonable expenses are those incurred in a calendar year for the purchase of a bicycle and bicycle improvements, repair, and storage, if the bicycle is regularly used for travel between the employee’s residence and place of employment.

Amounts that are excludible from gross income for income tax purposes are also excluded from wages for employment tax purposes.

The TCJA suspends the exclusion from gross income and wages for qualified bicycle commuting reimbursements.

2. Present State Law

State law conforms to the deduction in section 132(f), IRC.

3. Proposal in SB 2821, SD-1
The bill proposes to decouple from the suspension of section 132(f), IRC, in proposed section 235-2.4(h)(1), HRS, meaning that State law would still allow qualified bicycle commuting reimbursements to be excludable even if federal law does not.

4. **Comments of the Tax Foundation of Hawaii**

We generally recommend conforming to the federal changes and reducing the overall tax rate.

L. **Repeal of exclusion for qualified moving expense reimbursement (sec. 132(g) of the Code)**

1. **Description of Federal Change**

Qualified moving expense reimbursements are excluded from an employee’s gross income and are defined as any amount received (directly or indirectly) from an employer as payment for (or reimbursement of) expenses which would be deductible as moving expenses under section 217 if directly paid or incurred by the employee. However, any such amount actually deducted by the individual is not eligible for this exclusion. Amounts that are excludible from gross income for income tax purposes are also excluded from wages for employment tax purposes.

The TCJA repeals the exclusion from gross income and wages for qualified moving expense reimbursements except in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order.

2. **Present State Law**

State law conforms to the deduction in section 132(g), IRC.

3. **Proposal in SB 2821, SD-1**

The bill proposes to decouple from the suspension of section 132(g), IRC, in proposed section 235-2.4(h)(2), HRS, meaning that State law would still allow moving expense reimbursements to be excludable even if federal law does not.

4. **Comments of the Tax Foundation of Hawaii**

We generally recommend conforming to the federal changes and reducing the overall tax rate.

V. **SIMPLIFICATION AND REFORM OF SAVINGS, PENSIONS, RETIREMENT**

A. **Repeal of special rule permitting recharacterization of IRA contributions (sec. 408A of the Code)**

1. **Description of Federal Change**

   a) **Individual retirement arrangements**
There are two basic types of individual retirement arrangements ("IRAs") under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, to which only nondeductible contributions may be made. The principal difference between these two types of IRAs is the timing of income tax inclusion.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual’s IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount ($5,500 for 2017) or the individual’s compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. The dollar limit is increased annually ("indexed") as needed to reflect increases in the cost-of-living. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions up to $1,000 to an IRA. The IRA catch-up contribution limit is not indexed.

b) Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit (reduced by any contributions to Roth IRAs) if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income ("AGI") for the taxable year over certain indexed levels. To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible after-tax contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions. An individual who has attained age 70½ before the close of a year is not permitted to make contributions to a traditional IRA for that year.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of the individual’s basis. All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs.

c) Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of
contributions to the Roth IRA are not includible in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions.

d) Separation of traditional and Roth IRA accounts

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert an amount in a traditional IRA to a Roth IRA. The amount converted is includible in the taxpayer’s income as if a withdrawal had been made. The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

Rollovers to IRAs of distributions from tax-favored employer-sponsored retirement plans (that is, qualified retirement plans, tax-deferred annuity plans, and governmental eligible deferred compensation plans) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan generally must are contributed to a traditional IRA, and distributions from a designated Roth account under an employer-sponsored plan must be contributed only to a Roth IRA. However, a distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from a tax-favored employer-sponsored plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions).

e) Recharacterization of IRA contributions

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual’s income tax return for that year. In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

The amount transferred in a recharacterization must be accompanied by any net income allocable to the contribution. In general, even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a pro rata portion of income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may establish multiple Roth IRAs, for example, Roth IRAs with different investment strategies, and divide the amount being converted among the IRAs. The individual can then choose whether to recharacterize any of the Roth IRAs as a traditional IRA by transferring the entire amount in the particular Roth IRA to a traditional IRA. For example, if the value of the assets in a particular Roth IRA declines after the conversion, the conversion can be reversed by recharacterizing that IRA as a traditional
IRA. The individual may then later convert that traditional IRA to a Roth IRA (referred to as a reconversion), including only the lower value in income. Treasury regulations prevent the reconversion from taking place immediately after the recharacterization, by requiring a minimum period to elapse before the reconversion. Generally the reconversion cannot occur sooner than the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.

\[ j \quad \text{Description of Federal Change} \]

Under the TCJA, the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual’s income tax return for that year, recharacterize it as a contribution to a traditional IRA.

2. Present State Law

State law conforms to the deduction in section 408A, IRC, as provided in section 235-2.4(t), HRS. State law does not conform to the two-year ratable inclusion provision in section 408A(d)(3)(A)(iii), IRC.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to IRA recharacterizations, meaning that State law would conform to the federal changes.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

B. Extended rollover period for the rollover of plan loan offset amounts in certain cases (sec. 402 of the Code)

1. Description of Federal Change

a) Taxation of retirement plan distributions

A distribution from a tax-favored employer-sponsored retirement plan (that is, a qualified retirement plan, section 403(b) plan, or a governmental section 457(b) plan) is generally includible in gross income, except in the case of a qualified distribution from a designated Roth account or to the extent the distribution is a recovery of basis under the plan or the distribution is contributed to another such plan or an IRA (referred to as eligible retirement plans) in a tax-free rollover. In the case of a distribution from a retirement plan to an employee under age 59½, the distribution (other than a distribution from a governmental section 457(b) plan) is also subject to a 10-percent early distribution tax unless an exception applies.
A distribution from a tax-favored employer-sponsored retirement plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan. The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution (“60-day rollover”).

Employer-sponsored retirement plans are required to offer an employee a direct rollover with respect to any eligible rollover distribution before paying the amount to the employee. If an eligible rollover distribution is not directly rolled over to an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding. Employees who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20 percent withheld will remain taxable unless the employee substitutes funds within the 60-day period.

b) Plan loans

Employer-sponsored retirement plans may provide loans to employees. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan, including that the terms of the loan provide for a repayment period of not more than five years (except for a loan specifically to purchase a home) and for level amortization of loan payments with payments not less frequently than quarterly.291 Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan.

A plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employee’s obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount in employee’s account balance is offset by the amount of the unpaid loan balance, referred to as a loan offset. A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

a) Description of Federal Change

Under the TCJA, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the Federal income tax return for the taxable year in which the plan loan offset occurs, that is, the taxable year in which the amount is treated as distributed from the plan. Under the provision, a qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a section 403(b) plan or a governmental section 457(b) plan solely by reason of
the termination of the plan or the failure to meet the repayment terms of the loan because of the employee’s severance from employment. As under present law, a loan offset amount under the provision is the amount by which an employee’s account balance under the plan is reduced to repay a loan from the plan.

2. Present State Law

State law conforms to the provision in section 402, IRC.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to plan loan offsets, meaning that State law would conform to the federal changes.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

C. Modification of rules applicable to length of service award programs for bona fide public safety volunteers (sec. 457(e) of the Code)

1. Description of Federal Change
   a) Background

   Special rules apply to deferred compensation plans of State and local government and private, tax-exempt employers. However, an exception to these rules applies in the case of a plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of qualified services performed by the volunteers. For this purpose, qualified services consist of firefighting and fire prevention services, emergency medical services, and ambulance services. An individual is treated as a bona fide volunteer for this purpose if the only compensation received by the individual for performing qualified services is in the form of (1) reimbursement or a reasonable allowance for reasonable expenses incurred in the performance of such services, or (2) reasonable benefits (including length of service awards) and nominal fees for the services, customarily paid in connection with the performance of such services by volunteers. The exception applies only if the aggregate amount of length of service awards accruing for a bona fide volunteer with respect to any year of service does not exceed $3,000.

   b) Description of Change

   The TCJA increases the aggregate amount of length of service awards that may accrue for a bona fide volunteer with respect to any year of service to $6,000 and adjusts that amount in $500 increments to reflect changes in cost-of-living for years after the first year the provision is effective. In addition, under the provision, if the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. Actuarial present value is to be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the
most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant’s age at the time of the calculation.

2. Present State Law

State law conforms to the deduction in section 457, IRC, as provided in section 235-2.4(x), HRS. State law contains a special rule disallowing rollover treatment for distributions from a plan to obtain ERS retirement credits.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to length of service award programs, meaning that State law would conform to the federal changes.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

VI. ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAXES

A. Modifications to Estate, Gift, and Generation-Skipping Transfer Taxes (secs. 2001 and 2010 of the Code)

1. Description of Federal Change

A gift tax is imposed on certain lifetime transfers, and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Income tax rules determine the recipient’s tax basis in property acquired from a decedent or by gift. Gifts and bequests generally are excluded from the recipient’s gross income.

a) Common features of the estate, gift and generation-skipping transfer taxes

Unified credit.—A unified credit is available with respect to taxable transfers by gift and at death. The unified credit offsets tax, computed using the applicable estate and gift tax rates, on a specified amount of transfers, referred to as the applicable exclusion amount, or exemption amount. The exemption amount was set at $5 million for 2011 and is indexed for inflation for later years. For 2017, the inflation-indexed exemption amount is $5.49 million. Exemption used during life to offset taxable gifts reduces the amount of exemption that remains at death to offset the value of a decedent’s estate. An election is available under which exemption that is not used by a decedent may be used by the decedent’s surviving spouse (exemption portability).
Common tax rate table.—A common tax-rate table with a top marginal tax rate of 40 percent is used to compute gift tax and estate tax. The 40-percent rate applies to transfers in excess of $1 million (to the extent not exempt). Because the exemption amount currently shields the first $5.49 million in gifts and bequests from tax, transfers in excess of the exemption amount generally are subject to tax at the highest marginal rate (40 percent).

Generation-skipping transfer tax exemption and rate.—The generation-skipping transfer tax is a separate tax that can apply in addition to either the gift tax or the estate tax. The tax rate and exemption amount for generation-skipping transfer tax purposes, however, are set by reference to the estate tax rules. Generation-skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate (40 percent). Tax is imposed on cumulative generation-skipping transfers in excess of the generation-skipping transfer tax exemption amount in effect for the year of the transfer. The generation-skipping transfer tax exemption for a given year is equal to the estate tax exemption amount in effect for that year (currently $5.49 million).

b) Description of change.

The TCJA doubles the estate and gift tax exemption for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026. This is accomplished by increasing the basic exclusion amount provided in section 2010(c)(3) of the Code from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011.

As a conforming amendment to section 2010(g) (regarding computation of estate tax), the TCJA provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the section with respect to differences between the basic exclusion amount in effect: (1) at the time of the decedent’s death; and (2) at the time of any gifts made by the decedent.

2. Present State Law

State law in chapter 236E, HRS, imposes an estate tax and a generation-skipping transfer tax. State law does not impose a gift tax. Section 236E-6, HRS, provides for an applicable exclusion amount that is the same as the federal applicable exclusion amount, the exemption equivalent of the unified credit reduced by the amount of taxable gifts made by the decedent that reduces the amount of the federal applicable exclusion amount, or the exemption equivalent of the unified credit on the decedent's federal estate tax return, with adjustments for nonresidents and nonresidents not citizens.

3. Proposal in SB 2821, SD-1

Section 7 of the bill amends section 236E-6, HRS, to freeze the applicable exclusion amount pre-TCJA levels.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes in light of section 236E-5(a), HRS, which states, “It is the intent of this chapter, in addition to the essential purpose of
raising revenue, to conform the estate and generation-skipping transfer tax law of the State as closely as possible to the Internal Revenue Code, in order to simplify the filing of returns and minimize the taxpayers' burdens in complying with the estate and generation-skipping transfer tax law."

VII. ALTERNATIVE MINIMUM TAX

A. Individual alternative minimum tax (secs. 53 and 55-59 of the Code)
   1. Description of Federal Change

   The TCJA temporarily increases both the exemption amount and the exemption amount phaseout thresholds for the individual AMT. Under the provision, for taxable years beginning after December 31, 2017, and beginning before January 1, 2026, the AMT exemption amount is increased to $109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), and $70,300 for all other taxpayers (other than estates and trusts). The phaseout thresholds are increased to $1,000,000 for married taxpayers filing a joint return, and $500,000 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.

   2. Present State Law

   State law in section 235-2.3(b)(1), HRS, generally does not conform to the individual alternative minimum tax.

   3. Proposal in SB 2821, SD-1

   The bill contains no specific provision relating to alternative minimum tax, meaning that State law would not impose the tax.

   4. Comments of the Tax Foundation of Hawaii

   We generally recommend not imposing the alternative minimum tax, as is done now, to avoid further complexity.

B. Corporate alternative minimum tax (secs. 53 and 55-59 of the Code)
   1. Description of Federal Change

   The TCJA repeals the corporate alternative minimum tax.

   2. Present State Law

   State law in section 235-2.3(b)(1), HRS, generally does not conform to the corporate alternative minimum tax.

   3. Proposal in SB 2821, SD-1
The bill contains no specific provision relating to alternative minimum tax, meaning that State law would not impose the tax.

4. Comments of the Tax Foundation of Hawaii

We generally recommend not imposing the alternative minimum tax, as is done now, to avoid further complexity.

VIII. OTHER INDIVIDUAL PROVISIONS

A. Elimination of shared responsibility payment for individuals failing to maintain minimum essential coverage (sec. 5000A of the Code)

1. Description of Federal Change

Under the Patient Protection and Affordable Care Act (also called the Affordable Care Act, or “ACA”), individuals must be covered by a health plan that provides at least minimum essential coverage or be subject to a tax (also referred to as a penalty) for failure to maintain the coverage (commonly referred to as the “individual mandate”). Minimum essential coverage includes government-sponsored programs (including Medicare, Medicaid, and CHIP, among others), eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans and grandfathered health insurance coverage, and other coverage as recognized by the Secretary of Health and Human Services (“HHS”) in coordination with the Secretary of the Treasury. The tax is imposed for any month that an individual does not have minimum essential coverage unless the individual qualifies for an exemption for the month as described below.

The tax for any calendar month is one-twelfth of the tax calculated as an annual amount. The annual amount is equal to the greater of a flat dollar amount or an excess income amount. The flat dollar amount is the lesser of (1) the sum of the individual annual dollar amounts for the members of the taxpayer’s family and (2) 300 percent of the adult individual dollar amount. The individual adult annual dollar amount is $695 for 2017 and 2018. For an individual who has not attained age 18, the individual annual dollar amount is one half of the adult amount. The excess income amount is 2.5 percent of the excess of the taxpayer’s household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return. The total annual household payment may not exceed the national average annual premium for bronze level health plans for the applicable family size offered through Exchanges that year.

Exemptions from the requirement to maintain minimum essential coverage are provided for the following: (1) an individual for whom coverage is unaffordable because the required contribution exceeds 8.16 percent of household income, (2) an individual with household income below the income tax return filing threshold, (3) a member of an Indian tribe, (4) a member of certain recognized religious sects or a health sharing ministry, (5) an individual with a coverage gap for a continuous period of less than three months, and (6) an individual who is determined by the Secretary of HHS to have suffered a hardship with respect to the capability to obtain coverage.

The TCJA reduces the amount of the individual responsibility payment, enacted as part of the Affordable Care Act, to zero.
2. Present State Law

State law in section 235-2.3, HRS, generally does not conform to the IRC except for chapter 1. Section 5000A, IRC, is outside chapter 1 and Hawaii tax law generally does not conform to it.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to the individual shared responsibility payment, meaning that State law would not impose it.

4. Comments of the Tax Foundation of Hawaii

We generally recommend not imposing the individual shared responsibility payment, as is done now, to avoid further complexity. Hawaii’s Prepaid Health Care Act of 1974 already provides the population with a significant degree of coverage.

B. Temporarily allow increased contributions to ABLE accounts (sec. 529A of the Code)

1. Description of Federal Change

For background information on the ABLE accounts please see section III.E.1.a) above.

a) Saver's credit

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions. The maximum annual contribution eligible for the credit is $2,000 per individual. The credit rate depends on the adjusted gross income (“AGI”) of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

b) Description of change

The TCJA increases the limitation with respect to contributions made by the designated beneficiary of the ABLE account. Under the temporary provision, after the overall limitation on contributions is reached, an ABLE account’s designated beneficiary may contribute an additional amount, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual’s compensation for the taxable year.

Additionally, the provision temporarily allows a designated beneficiary of an ABLE account to claim the saver’s credit for contributions made to his or her ABLE account.

2. Present State Law
State law generally conforms to the ABLE account provisions in section 529A, IRC, under section 235-2.4(ee), HRS, except for section 529A(c)(3) (with respect to additional tax for distributions not used for disability expenses).

Federal credits are generally inoperative for State income tax purposes under section 235-2.3(b)(1), HRS. This is because state law provides its own set of credits.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to ABLE accounts, meaning that state law would incorporate the federal changes to ABLE accounts except as they relate to the federal savers’ credit.

4. Comments of the Tax Foundation of Hawaii

We generally recommend conforming to the federal changes and reducing the overall tax rate.

Traditionally, state law provides its own set of credits so there is no need to conform with federal credit provisions.

C. Extension of time limit for contesting IRS levy (secs. 6343 and 6532 of the Code)

1. Description of Federal Change

The IRS is authorized to return property that has been wrongfully levied upon. In general, monetary proceeds from the sale of levied property may be returned within nine months of the date of the levy.

Generally, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in levied property and that such property was wrongfully levied upon may bring a civil action for wrongful levy in a district court of the United States. Generally, an action for wrongful levy must be brought within nine months from the date of levy.

The TCJA extends from nine months to two years the period for returning the monetary proceeds from the sale of property that has been wrongfully levied upon.

The provision also extends from nine months to two years the period for bringing a civil action for wrongful levy.

Effective date.—The provision is effective with respect to: (1) levies made after the date of enactment; and (2) levies made on or before the date of enactment provided that the nine-month period has not expired as of the date of enactment.

2. Present State Law
State law in section 235-2.3, HRS, generally does not conform to the IRC except for chapter 1. The enforcement sections involved here are outside chapter 1 and Hawaii tax law generally does not conform to it.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to levies, meaning that state law would not incorporate the federal changes.

4. Comments of the Tax Foundation of Hawaii

The federal levy provisions are generally different from Hawaii provisions. We do not recommend conforming with the federal provisions at this time.

D. Treatment of certain individuals performing services in the Sinai Peninsula of Egypt (secs. 2, 112, 692, 2201, 3401, 4253, 6013, and 7508 of the Code)

1. Description of Federal Change

Members of the Armed Forces serving in a combat zone are afforded a number of tax benefits. These include:

1. An exclusion from gross income of certain military pay received for any month during which the member served in a combat zone or was hospitalized as a result of serving in a combat zone;

2. An exemption from taxes on death while serving in combat zone or dying as a result of wounds, disease, or injury incurred while so serving;

3. Special estate tax rules where death occurs in a combat zone;

4. Special benefits to surviving spouses in the event of a service member’s death or missing status;

5. An extension of time limits governing the filing of returns and other rules regarding timely compliance with Federal income tax rules; and

6. An exclusion from telephone excise taxes.

The provision grants combat zone tax benefits to the Sinai Peninsula of Egypt, if as of the date of enactment of the provision any member of the Armed Forces of the United States is entitled to special pay under section 310 of title 37, United States Code (relating to special pay; duty subject to hostile fire or imminent danger), for services performed in such location. This benefit lasts only during the period such entitlement is in effect but not later than taxable years beginning before January 1, 2026.
Effective date.—The provision is generally effective beginning June 9, 2015. The portion of the provision related to wage withholding applies to remuneration paid after the date of enactment.

2. Present State Law

State law generally conforms to the exclusion from gross income of combat zone military pay in section 112, IRC.

State law generally conforms to the exemption for taxes upon death in a combat zone in section 692, IRC.

State law generally conforms to special estate tax rules when death occurs in a combat zone in 2201, IRC.

State law generally does not conform to special provisions for surviving spouses in sections 2 and 6013, IRC. Section 235-2.3(b)(1), HRS, decouples from section 2, IRC. Section 235-2.3(a), HRS, states that Hawaii income tax law generally conforms to chapter 1, IRC, and section 6013, IRC, is not in chapter 1, IRC; furthermore, state law has its own rules regarding returns and joint returns in sections 235-92 and -93, HRS.

State law does not impose telephone excise taxes.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to individuals performing service in the Sinai Peninsula, meaning that state law would incorporate the federal changes to sections 112, 692, and 2201, IRC, and disregard the balance.

4. Comments of the Tax Foundation of Hawaii

We recommend no change to the treatment proposed in the bill.

E. Relief for 2016 disaster areas (secs. 72(t), 165, 401-403, 408, 457, and 3405 of the Code)

1. Description of Federal Change

   a) Distributions from tax-favored retirement plans

A distribution from a qualified retirement plan, a tax-sheltered annuity plan (a “section 403(b) plan”), an eligible deferred compensation plan of a State or local government employer (a “governmental section 457(b) plan”), or an individual retirement arrangement (an “IRA”) generally is included in income for the year distributed. These plans are referred to collectively as “eligible retirement plans.” In addition, unless an exception applies, a distribution from a qualified retirement plan, a section 403(b) plan, or an IRA received before age 59½ is subject to a 10-percent additional tax (referred to as the “early withdrawal tax”) on the amount includible in income.
In general, a distribution from an eligible retirement plan may be rolled over to another eligible retirement plan within 60 days, in which case the amount rolled over generally is not includible in income. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster or other events beyond the reasonable control of the individual.

The terms of a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan generally determine when distributions are permitted. However, in some cases, restrictions may apply to distribution before an employee’s termination of employment, referred to as “in-service” distributions. Despite such restrictions, an in-service distribution may be permitted in the case of financial hardship or an unforeseeable emergency.

Tax-favored retirement plans are generally required to be operated in accordance with the terms of the plan document, and amendments to reflect changes to the plan generally must be adopted within a limited period.

b) Itemized deduction for casualty losses

A taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise. For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer’s adjusted gross income.

c) Relief for 2016 disaster areas

The TCJA provides tax relief, as described below, relating to a “2016 disaster area,” defined as any area with respect to which a major disaster was declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act during calendar year 2016.

(1) Distributions from eligible retirement plans

Under the provision, an exception to the 10-percent early withdrawal tax applies in the case of a qualified 2016 disaster distribution from a qualified retirement plan, a section 403(b) plan or an IRA. In addition, as discussed further, income attributable to a qualified 2016 disaster distribution may be included in income ratably over three years, and the amount of a qualified 2016 disaster distribution may be recontributed to an eligible retirement plan within three years.

A qualified 2016 disaster distribution is a distribution from an eligible retirement plan made on or after January 1, 2016, and before January 1, 2018, to an individual whose principal place of abode at any time during calendar year 2016 was located in a 2016 disaster area and who has sustained an economic loss by reason of the events giving rise to the Presidential disaster declaration.
The total amount of distributions to an individual from all eligible retirement plans that may be treated as qualified 2016 disaster distributions is $100,000. Thus, any distributions in excess of $100,000 during the applicable period are not qualified 2016 disaster distributions.

Any amount required to be included in income as a result of a qualified 2016 disaster is included in income ratably over the three-year period beginning with the year of distribution unless the individual elects not to have ratable inclusion apply.

Any portion of a qualified 2016 disaster distribution may, at any time during the three-year period beginning the day after the date on which the distribution was received, be recontributed to an eligible retirement plan to which a rollover can be made. Any amount recontributed within the three-year period is treated as a rollover and thus is not includible in income. For example, if an individual receives a qualified 2016 disaster distribution in 2016, that amount is included in income, generally ratably over the year of the distribution and the following two years, but is not subject to the 10-percent early withdrawal tax. If, in 2018, the amount of the qualified 2016 disaster distribution is recontributed to an eligible retirement plan, the individual may file an amended return to claim a refund of the tax attributable to the amount previously included in income. In addition, if, under the ratable inclusion provision, a portion of the distribution has not yet been included in income at the time of the contribution, the remaining amount is not includible in income.

A qualified 2016 disaster distribution is a permissible distribution from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan, regardless of whether a distribution otherwise would be permissible. A plan is not treated as violating any Code requirement merely because it treats a distribution as a qualified 2016 disaster distribution, provided that the aggregate amount of such distributions from plans maintained by the employer and members of the employer’s controlled group or affiliated service group does not exceed $100,000. Thus, a plan is not treated as violating any Code requirement merely because an individual might receive total distributions in excess of $100,000, taking into account distributions from plans of other employers or IRAs.

A plan amendment made pursuant to the provision (or a regulation issued thereunder) may be retroactively effective if, in addition to the requirements described below, the amendment is made on or before the last day of the first plan year beginning after December 31, 2018 (or in the case of a governmental plan, December 31, 2020), or a later date prescribed by the Secretary. In addition, the plan will be treated as operated in accordance with plan terms during the period beginning with the date the provision or regulation takes effect (or the date specified by the plan if the amendment is not required by the provision or regulation) and ending on the last permissible date for the amendment (or, if earlier, the date the amendment is adopted). In order for an amendment to be retroactively effective, it must apply retroactively for that period, and the plan must be operated in accordance with the amendment during that period.

(2) Modification of rules related to casualty losses

Under the TCJA, in the case of a personal casualty loss which arose on or after January 1, 2016, in a 2016 disaster area and was attributable to the events giving rise to the Presidential disaster declaration, such losses are deductible without regard to whether aggregate net losses
exceed ten percent of a taxpayer’s adjusted gross income. Under the provision, in order to be deductible, the losses must exceed $500 per casualty. Additionally, such losses may be claimed in addition to the standard deduction.

Effective date.—The provision applies to losses arising in taxable years beginning after December 31, 2015, and before January 1, 2018. (As noted in section IV.D above, the personal casualty loss deduction was suspended effective January 1, 2018, except for Presidentially declared natural disasters.)

2. Present State Law

State law, under section 235-2.4(t), HRS, generally conforms to the rules regarding operation of qualified plans and individual retirement accounts in sections 410 to 417, HRS. State law, however, does not impose a penalty tax upon early distributions from a qualified plan or IRA under section 72(t), IRC, under section 235-2.4(c), HRS.

3. Proposal in SB 2821, SD-1

The bill contains no specific provision relating to casualty losses connected with a federally declared disaster, meaning that state law would incorporate the federal changes to the qualified plan provisions. Additionally, state law does not impose an early distribution penalty in any event.

4. Comments of the Tax Foundation of Hawaii

We recommend no change to the treatment proposed in the bill.

IX. BUSINESS TAX REFORM

A. Reduction in corporate tax rate (secs. 11 and 243 of the Code)

1. Description of Federal Change

   a) Corporate Tax Rate

Corporate taxable income is subject to tax under a four-step graduated rate structure. The top corporate tax rate is 35 percent on taxable income in excess of $10 million. The corporate taxable income brackets and tax rates are as set forth in the table below.

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax rate (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Not over $50,000</td>
<td>15</td>
</tr>
<tr>
<td>Over $50,000 but not over $75,000</td>
<td>25</td>
</tr>
<tr>
<td>Over $75,000 but not over $10,000,000</td>
<td>34</td>
</tr>
<tr>
<td>Over $10,000,000</td>
<td>35</td>
</tr>
</tbody>
</table>
An additional five-percent tax is imposed on a corporation’s taxable income in excess of $100,000. The maximum additional tax is $11,750. Also, a second additional three-percent tax is imposed on a corporation’s taxable income in excess of $15 million. The maximum second additional tax is $100,000.

Certain personal service corporations pay tax on their entire taxable income at the rate of 35 percent.

Present law provides that, if the maximum corporate tax rate exceeds 35 percent, the maximum rate on a corporation’s net capital gain will be 35 percent.

b) Dividends received deduction

Corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations. The amount of the deduction is generally equal to 70 percent of the dividend received.

In the case of any dividend received from a 20-percent owned corporation, the amount of the deduction is equal to 80 percent of the dividend received. The term “20-percent owned corporation” means any corporation if 20 percent or more of the stock of such corporation (by vote and value) is owned by the taxpayer. For this purpose, certain preferred stock is not taken into account.

In the case of a dividend received from a corporation that is a member of the same affiliated group, a corporation is generally allowed a deduction equal to 100 percent of the dividend received.

c) Description of Change

The TCJA eliminates the graduated corporate rate structure and instead taxes corporate taxable income at 21 percent.

The provision repeals the maximum corporate tax rate on net capital gain as obsolete. The provision reduces the 70 percent dividends received deduction to 50 percent and the 80 percent dividends received deduction to 65 percent.

Special rules apply to taxpayers subject to the normalization method of accounting (e.g., regulated public utilities).

2. Present State Law

State law does not conform to the ordinary income or capital gains rates because state rates are provided in sections 235-71 and 235-71.5, HRS, for ordinary income and capital gains. In general, the maximum marginal rate for corporations is 6.4 per cent with a 4 per cent maximum rate for capital gains.
State law does not conform to the dividends received deduction in section 243, IRC, under sections 235-2.3(b)(17) and 235-7(c), HRS.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes in ordinary income or capital gains corporate tax rates.

The bill does not propose any change to the corporate dividends received deduction in HRS section 235-7(c).

4. Comments of the Tax Foundation of Hawaii

We recommend that the Committee consider furthering the federal simplification efforts by adopting most of the federal changes. Rate relief for corporations may not be necessary because there is already a significant difference between individual and corporate rates.

B. Increased expensing (sec. 168(k) of the Code)

1. Description of Federal Change

   a) Depreciation generally

   A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.

   Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.

   b) Bonus depreciation

   An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2020 (January 1, 2021, for longer production period property and certain aircraft). The 50- percent allowance is phased down for property placed in service after December 31, 2017 (after December 31, 2018 for longer production period property and certain aircraft). The bonus depreciation percentage rates are as follows.

<table>
<thead>
<tr>
<th>Placed in Service Year</th>
<th>Bonus Depreciation Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Qualified Property in General</td>
</tr>
<tr>
<td>2017</td>
<td>50 percent</td>
</tr>
<tr>
<td>2018</td>
<td>40 percent</td>
</tr>
<tr>
<td>2019</td>
<td>30 percent</td>
</tr>
</tbody>
</table>
The additional first-year depreciation deduction is allowed for both the regular tax and the alternative minimum tax ("AMT"), but is not allowed in computing earnings and profits. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction. The amount of the additional first-year depreciation deduction is not affected by a short taxable year. The taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year.

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2017 a taxpayer purchases new depreciable property and places it in service. The property’s cost is $10,000, and it is five-year property subject to the 200 percent declining balance method and half-year convention. The amount of additional first-year depreciation allowed is $5,000. The remaining $5,000 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, $1,000 also is allowed as a depreciation deduction in 2017. The total depreciation deduction with respect to the property for 2017 is $6,000. The remaining $4,000 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

c) Qualified property

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements. First, the property must be: (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property; (3) computer software other than computer software covered by section 197; or (4) qualified improvement property. Second, the original use of the property must commence with the taxpayer. Third, the taxpayer must acquire the property within the applicable time period (as described below). Finally, the property must be placed in service before January 1, 2020. As noted above, an extension of the placed-in-service date of one year (i.e., before January 1, 2021) is provided for certain property with a recovery period of 10 years or longer, certain transportation property, and certain aircraft.

To qualify, property must be acquired (1) before January 1, 2020, or (2) pursuant to a binding written contract which was entered into before January 1, 2020. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property before January 1, 2020. Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer. For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2020 ("progress expenditures") is eligible for the additional first-year depreciation deduction.

d) Qualified improvement property
Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

e) Election to accelerate AMT credits in lieu of bonus depreciation

A corporation otherwise eligible for additional first-year depreciation may elect to claim additional AMT credits in lieu of claiming additional depreciation with respect to qualified property. In the case of a corporation making this election, the straight line method is used for the regular tax and the AMT with respect to qualified property.

A corporation making an election increases the tax liability limitation under section 53(c) on the use of minimum tax credits by the bonus depreciation amount. The aggregate increase in credits allowable by reason of the increased limitation is treated as refundable.

The bonus depreciation amount generally is equal to 20 percent of bonus depreciation for qualified property that could be claimed as a deduction absent an election under this provision. As originally enacted, the bonus depreciation amount for all taxable years was limited to the lesser of (1) $30 million or (2) six percent of the minimum tax credits allocable to the adjusted net minimum tax imposed for taxable years beginning before January 1, 2006. However, extensions of this provision have provided that this limitation applies separately to property subject to each extension.

For taxable years ending after December 31, 2015, the bonus depreciation amount for a taxable year (as defined under present law with respect to all qualified property) is limited to the lesser of (1) 50 percent of the minimum tax credit for the first taxable year ending after December 31, 2015 (determined before the application of any tax liability limitation) or (2) the minimum tax credit for the taxable year allocable to the adjusted net minimum tax imposed for taxable years ending before January 1, 2016 (determined before the application of any tax liability limitation and determined on a first-in, first-out basis).

All corporations treated as a single employer under section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.

In the case of a corporation making an election which is a partner in a partnership, for purposes of determining the electing partner’s distributive share of partnership items, bonus depreciation does not apply to any qualified property and the straight line method is used with respect to that property.

In the case of a partnership having a single corporate partner owning (directly or indirectly) more than 50 percent of the capital and profits interests in the partnership, each partner takes into account its distributive share of partnership depreciation in determining its bonus depreciation amount.

f) Passenger automobiles
The limitation under section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction). The $8,000 amount is phased down from $8,000 by $1,600 per calendar year beginning in 2018. Thus, the section 280F increase amount for property placed in service during 2018 is $6,400, and during 2019 is $4,800. While the underlying section 280F limitation is indexed for inflation, the section 280F increase amount is not indexed for inflation. The increase does not apply to a taxpayer who elects to accelerate AMT credits in lieu of bonus depreciation for a taxable year.

g) Certain plants bearing fruits and nuts

A special election is provided for certain plants bearing fruits and nuts. Under the election, the applicable percentage of the adjusted basis of a specified plant which is planted or grafted after December 31, 2015, and before January 1, 2020, is deductible for regular tax and AMT purposes in the year planted or grafted by the taxpayer, and the adjusted basis is reduced by the amount of the deduction. The percentage is 50 percent for 2017, 40 percent for 2018, and 30 percent for 2019. A specified plant is any tree or vine that bears fruits or nuts, and any other plant that will have more than one yield of fruits or nuts and generally has a preproductive period of more than two years from planting or grafting to the time it begins bearing fruits or nuts. The election is revocable only with the consent of the Secretary, and if the election is made with respect to any specified plant, such plant is not treated as qualified property eligible for bonus depreciation in the subsequent taxable year in which it is placed in service.

h) Long-term contracts

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method. Solely for purposes of determining the percentage of completion under section 460(b)(1)(A), the cost of qualified property with a MACRS recovery period of seven years or less is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted for property placed in service before January 1, 2020 (January 1, 2021, in the case of longer production period property).

i) Intangible property

MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years. Section 197 (amortization of goodwill and certain other intangibles) does not apply to certain intangible property, including certain property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof. Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a “stand-alone” basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the section 197 amortization provisions. The cost recovery of such property may be determined under section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the
property if it is used in a trade or business or held for the production of income. In addition, the costs of motion picture films, video tapes, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.

j) Expensing of certain qualified film, television and live theatrical productions

Under section 181, a taxpayer may elect to deduct the cost of any qualifying film, television and live theatrical production, commencing prior to January 1, 2017, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances. A taxpayer may elect to deduct up to $15 million of the aggregate cost of the film or television production under this section. The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.

A qualified film, television or live theatrical production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format), television program or live staged play if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel. The term “compensation” does not include participations and residuals (as defined in section 167(g)(7)(B)).

Each episode of a television series is treated as a separate production, and only the first 44 episodes of a particular series qualify under the provision. Qualified productions do not include sexually explicit productions as referenced by section 2257 of title 18 of the U.S. Code.

A qualified live theatrical production is defined as a live staged production of a play (with or without music) which is derived from a written book or script and is produced or presented by a commercial entity in any venue which has an audience capacity of not more than 3,000, or a series of venues the majority of which have an audience capacity of not more than 3,000. In addition, qualified live theatrical productions include any live staged production which is produced or presented by a taxable entity no more than 10 weeks annually in any venue which has an audience capacity of not more than 6,500. In general, in the case of multiple live-staged productions, each such live-staged production is treated as a separate production.

Similar to the exclusion for sexually explicit productions from the definition of qualified film or television productions, qualified live theatrical productions do not include stage performances that would be excluded by section 2257(h)(1) of title 18 of the U.S. Code, if such provision were extended to live stage performances.

For purposes of recapture under section 1245, any deduction allowed under section 181 is treated as if it were a deduction allowable for amortization.

k) Full expensing for certain business assets

Under the TCJA, the bonus depreciation rates are as follows.
<table>
<thead>
<tr>
<th>Placed in Service Year</th>
<th>Bonus Depreciation Percentage</th>
<th>Longer Production Period Property and Certain Aircraft</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Qualified Property in General/Specified Plants</td>
<td></td>
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<tr>
<td></td>
<td>Portion of Basis of Qualified Property</td>
<td>Acquired before Sept. 28, 2017</td>
</tr>
<tr>
<td></td>
<td></td>
<td>50 percent</td>
</tr>
<tr>
<td>Sept. 28, 2017 – Dec. 31, 2017</td>
<td>40 percent</td>
<td>50 percent</td>
</tr>
<tr>
<td>2018</td>
<td>30 percent</td>
<td>40 percent</td>
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<tr>
<td>2019</td>
<td>None</td>
<td>30 percent</td>
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<tr>
<td>2020</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td>2021 and thereafter</td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td></td>
<td>Portion of Basis of Qualified Property</td>
<td>Acquired after Sept. 27, 2017</td>
</tr>
<tr>
<td>Sept. 28, 2017 – Dec. 31, 2022</td>
<td>100 percent</td>
<td>100 percent</td>
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<tr>
<td>2023</td>
<td>80 percent</td>
<td>100 percent</td>
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<tr>
<td>2024</td>
<td>60 percent</td>
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<td>2026</td>
<td>20 percent</td>
<td>40 percent</td>
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<tr>
<td>2027</td>
<td>None</td>
<td>20 percent</td>
</tr>
<tr>
<td>2028 and thereafter</td>
<td>None</td>
<td>None</td>
</tr>
</tbody>
</table>

As a conforming amendment to the repeal of corporate AMT, the TCJA repeals the election to accelerate AMT credits in lieu of bonus depreciation.

Effective date.—The provision generally applies to property acquired and placed in service after September 27, 2017, and to specified plants planted or grafted after such date.

A transition rule provides that, for a taxpayer’s first taxable year ending after September 27, 2017, the taxpayer may elect to apply a 50-percent allowance instead of the 100-percent allowance.

1) Application to used property

The TCJA removes the requirement that the original use of qualified property must commence with the taxpayer. Thus, the provision applies to purchases of used as well as new items. To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm’s-length transaction. It does not apply to property received as a gift or from a decedent. In the case of trade-ins, like-kind exchanges, or involuntary conversions, it applies only to any money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property. It does not apply to property acquired in a nontaxable exchange such as a reorganization, to property acquired from a member of the
taxpayer’s family, including a spouse, ancestors, and lineal descendants, or from another related entity as defined in section 267, nor to property acquired from a person who controls, is controlled by, or is under common control with, the taxpayer. Thus it does not apply, for example, if one member of an affiliated group of corporations purchases property from another member, or if an individual who controls a corporation purchases property from that corporation.

2. **Present State Law**

State law does conform to the general and MACRS depreciation systems in sections 167 and 168, IRC, as provided in section 235-2.4(k), HRS. State law does not conform to bonus depreciation in section 168(k), IRC, as provided in section 235-2.4(k), HRS.

State law does not conform to the special rules in section 181, IRC, relating to motion picture and television film production expensing, per section 235-2.3(b)(13), HRS.

3. **Proposal in SB 2821, SD-1**

The bill does not propose any changes in section 168, IRC, meaning that the State would continue to reject bonus depreciation in section 168(k), IRC.

4. **Comments of the Tax Foundation of Hawaii**

We recommend that the Committee consider furthering the federal simplification efforts by adopting most of the federal changes, although we can certainly understand decoupling from the federal bonus depreciation provisions because the State, like other states, has already done so for many years.

C. **Modifications to depreciation limitations on luxury automobiles and personal use property (sec. 280F of the Code)**

1. **Description of Federal Change**

   a) **Present Law**

Section 280F(a) limits the annual cost recovery deduction with respect to certain passenger automobiles. This limitation is commonly referred to as the “luxury automobile depreciation limitation.” For passenger automobiles placed in service in 2017, and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the maximum amount of allowable depreciation is $3,160 for the year in which the vehicle is placed in service, $5,100 for the second year, $3,050 for the third year, and $1,875 for the fourth and later years in the recovery period. This limitation is indexed for inflation and applies to the aggregate deduction provided under present law for depreciation and section 179 expensing. Hence, passenger automobiles subject to section 280F are eligible for section 179 expensing only to the extent of the applicable limits contained in section 280F. For passenger automobiles eligible for the additional first-year depreciation allowance in 2017, the first-year limitation is increased by an additional $8,000.
For purposes of the depreciation limitation, passenger automobiles are defined broadly to include any four-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less. In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sport utility vehicles are treated as a truck for the purpose of applying the section 280F limitation.

Basis not recovered in the recovery period of a passenger automobile is allowable as an expense in subsequent taxable years. The expensed amount is limited in each such subsequent taxable year to the amount of the limitation in the fourth year in the recovery period.

b) Listed property

In the case of certain listed property, special rules apply. Listed property generally is defined as (1) any passenger automobile; (2) any other property used as a means of transportation; (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment; and (5) any other property of a type specified in Treasury regulations.

First, if for the taxable year in which the property is placed in service, the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system. The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property. Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment. Both limitations apply for purposes of section 179 expensing.

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property. A taxpayer must substantiate the elements of each expenditure or use of listed property, including (1) the amount (e.g., cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (e.g., mileage for automobiles), and the total use of the property for the taxable period, (2) the date of the expenditure or use, and (3) the business purposes for the expenditure or use. The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must contain sufficient information as to each element of every business or investment use.

c) Description of Change

The provision increases the depreciation limitations under section 280F that apply to listed property. For passenger automobiles placed in service after December 31, 2017, and for which the additional first-year depreciation deduction under section 168(k) is not claimed, the maximum amount of allowable depreciation is $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the
fourth and later years in the recovery period. The limitations are indexed for inflation for passenger automobiles placed in service after 2018.

The provision removes computer or peripheral equipment from the definition of listed property. Such property is therefore not subject to the heightened substantiation requirements that apply to listed property.

Effective date.—The provision is effective for property placed in service after December 31, 2017, in taxable years ending after such date.

2. Present State Law

State law does conform to section 280F, IRC.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to limitations on luxury autos or similar items in section 280F, IRC, meaning that the State would conform to changes in section 280F, IRC.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to section 280F, IRC.

D. Modifications of treatment of certain farm property (sec. 168 of the Code)

1. Description of Federal Change
   a) Present Law

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5
years for residential rental property. The straight line depreciation method is required for the aforementioned real property.

Property used in a farming business is assigned various recovery periods in the same manner as other business property. For example, depreciable assets used in agriculture activities that are assigned a recovery period of 7 years include machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agriculture, animal husbandry, and horticultural services. Cotton ginning assets are also assigned a recovery period of 7 years. Any single purpose agricultural or horticultural structure, and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years. Land improvements such as drainage facilities, paved lots, and water wells are assigned a recovery period of 15 years.

A 5-year recovery period was assigned to new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which was used in a farming business, the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010.

Any property (other than nonresidential real property, residential rental property, and trees or vines bearing fruits or nuts) used in a farming business is subject to the 150-percent declining balance method.

Under a special accounting rule, certain taxpayers engaged in the business of farming who elect to deduct preproductive period expenditures are required to depreciate all farming assets using the alternative depreciation system (i.e., using longer recovery periods and the straight line method).

b) Description of Change

The TCJA shortens the recovery period from 7 to 5 years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business, the original use of which commences with the taxpayer and is placed in service after December 31, 2017.

The provision also repeals the required use of the 150-percent declining balance method for property used in a farming business (i.e., for 3-, 5-, 7-, and 10-year property). The 150-percent declining balance method will continue to apply to any 15-year or 20-year property used in the farming business to which the straight line method does not apply, or to property for which the taxpayer elects the use of the 150-percent declining balance method.

For these purposes, the term “farming business” means a farming business as defined in section 263A(e)(4). Thus, the term “farming business” means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity (e.g., the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals). A farming business
includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer.

2. **Present State Law**

State law does conform to the special rules for farm property in section 168, IRC.

3. **Proposal in SB 2821, SD-1**

The bill does not propose any changes relating to farm property in section 168, IRC, meaning that the State would conform to changes in section 168, IRC.

4. **Comments of the Tax Foundation of Hawaii**

We recommend continued conformity to the special rules for farm property in section 168, IRC.

E. **Applicable recovery period for real property (sec. 168 of the Code)**

1. **Description of Federal Change**
   
   a) **Present Law**

   A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.

   (1) **Recovery periods and depreciation methods**

   The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. The “type of property” of an asset is used to determine the “class life” of the asset, which in turn dictates the applicable recovery period for the asset.

   The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. The straight line depreciation method is required for the aforementioned real property.

   (2) **Placed-in-service conventions**
Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention. Under MACRS, nonresidential real property, residential rental property, and any railroad grading or tunnel bore generally are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month. All other property generally is subject to the half-year convention, which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year to reflect the assumption that assets are placed in service ratably throughout the year. However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use of the mid-quarter convention, designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

b) Depreciation of additions or improvements to property

The recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service. Any MACRS deduction for an addition or improvement to any property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of an improvement to a building that constitutes nonresidential real property is recovered over 39 years using the straight line method and mid-month convention. Certain improvements to nonresidential real property are eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met (i.e., improvements that constitute “qualified improvement property”).

c) Qualified improvement property

Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service. Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

d) Depreciation of leasehold improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease. This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions to the 39-year recovery period exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.
e) Qualified leasehold improvement property

Section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property. Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met. The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified leasehold improvement property is generally recovered using the straight-line method and a half-year convention, and is eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met.

f) Qualified restaurant property

Section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property. Qualified restaurant property is any section 1250 property that is a building or an improvement to a building, if more than 50 percent of the building’s square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals. Qualified restaurant property is recovered using the straight-line method and a half-year convention. Additionally, qualified restaurant property is not eligible for the additional first-year depreciation deduction unless it also satisfies the definition of qualified improvement property.

g) Qualified retail improvement property

Section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period for qualified retail improvement property. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service. Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. In the case of an improvement made by the owner of such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are
not limited to, grocery stores, clothing stores, hardware stores, and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. Generally, it is intended that businesses defined as a store retailer under the current North American Industry Classification System (industry sub-sectors 441 through 453) qualify while those in other industry classes do not qualify.

Qualified retail improvement property is recovered using the straight-line method and a half-year convention, and is eligible for the additional first-year depreciation deduction if the other requirements of section 168(k) are met.

\textit{h) Alternative depreciation system}

The alternative depreciation system ("ADS") is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain imported property covered by an Executive order. An election to use ADS is available to taxpayers for any class of property for any taxable year. Under ADS, all property is depreciated using the straight line method over recovery periods which generally are equal to the class life of the property, with certain exceptions. For example nonresidential real and residential rental property have a 40-year ADS recovery period, while qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property have a 39-year ADS recovery period.

\textit{i) Description of Change}

The TCJA eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, and provides a general 15-year recovery period for qualified improvement property, and a 20-year ADS recovery period for such property. The provision also requires a real property trade or business electing out of the limitation on the deduction for interest to use ADS to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property.

2. \textbf{Present State Law}

State law does conform to the rules for depreciating real property in section 168, IRC.

3. \textbf{Proposal in SB 2821, SD-1}

The bill does not propose any changes relating to real property in section 168, IRC, meaning that the State would conform to changes in section 168, IRC.

4. \textbf{Comments of the Tax Foundation of Hawaii}

We recommend continued conformity to the special rules for real property in section 168, IRC.
F. Use of alternative depreciation system for electing farming businesses (sec. 168 of the Code)

1. Description of Federal Change
   a) Present Law

   A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system (“MACRS”), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.

   The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. The “type of property” of an asset is used to determine the “class life” of the asset, which in turn dictates the applicable recovery period for the asset.

   The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods, switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. The straight line depreciation method is required for the aforementioned real property.

   Property used in a farming business is assigned various recovery periods in the same manner as other business property. For example, depreciable assets used in agriculture activities that are assigned a recovery period of 7 years include machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agriculture, animal husbandry, and horticultural services. Cotton ginning assets are also assigned a recovery period of 7 years. Any single purpose agricultural or horticultural structure, and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years. Land improvements such as drainage facilities, paved lots, and water wells are assigned a recovery period of 15 years.

   A 5-year recovery period was assigned to new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which was used in a farming business, the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010.

   Any property (other than nonresidential real property, residential rental property, and trees or vines bearing fruits or nuts) used in a farming business is subject to the 150- percent declining balance method.

   b) Alternative depreciation system
The alternative depreciation system ("ADS") is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain imported property covered by an Executive order. An election to use ADS is available to taxpayers for any class of property for any taxable year. Under ADS, all property is depreciated using the straight line method over recovery periods which generally are equal to the class life of the property, with certain exceptions. For example, any single purpose agricultural or horticultural structure has a 15-year ADS recovery period, while any tree or vine bearing fruit or nuts has a 20-year ADS recovery period. Similarly, land improvements such as drainage facilities, paved lots, and water wells have an ADS recovery period of 20 years.

Under a special accounting rule, certain taxpayers engaged in the business of farming who elect to deduct preproductive period expenditures under the uniform capitalization rules are required to depreciate all farming assets using ADS.

c) Description of Change

The provision requires an electing business, i.e., a farming business electing out of the limitation on the deduction for interest, to use ADS to depreciate any property with a recovery period of 10 years or more (e.g., property such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings, and certain land improvements).

2. Present State Law

State law does conform to the rules for depreciating farm property in section 168, IRC.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to farm property in section 168, IRC, meaning that the State would conform to changes in section 168, IRC.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to the special rules for farm property in section 168, IRC.

G. Expensing of certain costs of replanting citrus plants lost by reason of casualty (sec. 263A of the Code)

1. Description of Federal Change

a) Present Law

The uniform capitalization ("UNICAP") rules, which were enacted as part of the Tax Reform Act of 1986, require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be either capitalized into the basis of such property or included in inventory, as applicable. For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to
such property to be either capitalized into the basis of such property or included in inventory, as applicable.

Section 263A generally requires the capitalization of the direct and indirect costs allocable to the production of any property in a farming business, including animals and plants without regard to the length of their preproductive period. The costs of a plant generally required to be capitalized under section 263(a) include preparatory costs incurred so that the plant’s growing process may begin, such as the acquisition costs of the seed, seedling, or plant. Under section 263A, the costs of producing a plant generally required to be capitalized also include the preproductive period costs of planting, cultivating, maintaining, and developing the plant during the preproductive period. Preproductive period costs may include management, irrigation, pruning, soil and water conservation, fertilizing, frost protection, spraying, harvesting, storage and handling, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes, and interest, as applicable.

b) Special rules for plant farmers

Section 263A provides an exception to the general capitalization requirements for taxpayers who raise, harvest, or grow trees. Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any plant having a preproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)). Hence, in general, the UNICAP rules apply to the production of plants that have a preproductive period of more than two years, and to taxpayers required to use an accrual method of accounting.

Plant farmers otherwise required to capitalize preproductive period costs may elect to deduct such costs currently, provided the alternative depreciation system described in section 168(g)(2) is used on all farm assets and the preproductive period costs are recaptured upon disposition of the product. The election is not available to taxpayers required to use the accrual method of accounting. Moreover, the election is not available with respect to certain costs attributable to planting, cultivating, maintaining, or developing citrus or almond groves.

Section 263A does not apply to costs incurred in replanting edible crops for human consumption following loss or damage due to freezing temperatures, disease, drought, pests, or casualty. The same type of crop as the lost or damaged crop must be replanted. However, the exception to capitalization still applies if the replanting occurs on a parcel of land other than the land on which the damage occurred provided the acreage of the new land does not exceed that of the land to which the damage occurred and the new land is located in the United States. This exception may also apply to costs incurred by persons other than the taxpayer who incurred the loss or damage, provided (1) the taxpayer who incurred the loss or damage retains an equity interest of more than 50 percent in the property on which the loss or damage occurred at all times during the taxable year in which the replanting costs are paid or incurred, and (2) the person holding a minority equity interest and claiming the deduction materially participates in the planting, maintenance, cultivation, or development of the property during the taxable year in which the replanting costs are paid or incurred.
c) **Description of Change**

The provision modifies the special rule for costs incurred by persons other than the taxpayer in connection with replanting an edible crop for human consumption following loss or damage due to casualty. Under the provision, with respect to replanting costs paid or incurred after the date of enactment, but no later than a date which is ten years after such date of enactment, for citrus plants lost or damaged due to casualty, such replanting costs may also be deducted by a person other than the taxpayer if (1) the taxpayer has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which the replanting costs are paid or incurred and such other person holds any part of the remaining equity interest, or (2) such other person acquires all of the taxpayer’s equity interest in the land on which the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

2. **Present State Law**

State law conforms to the capitalization rules in section 263A, IRC.

3. **Proposal in SB 2821, SD-1**

The bill does not propose any changes relating to capitalization in section 263A, IRC, meaning that the State would conform to changes in section 263A, IRC.

4. **Comments of the Tax Foundation of Hawaii**

We recommend continued conformity to the rules for capitalization in section 263A, IRC.

**X. SMALL BUSINESS REFORMS**

**A. Expansion of section 179 expensing (sec. 179 of the Code)**

1. **Description of Federal Change**
   
   a) **Present Law**

   A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization. Tangible property generally is depreciated under the modified accelerated cost recovery system ("MACRS"), which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.

   b) **Election to expense certain depreciable business assets**

   A taxpayer may elect under section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation. The maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year. The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the
taxable year exceeds $2,000,000. The $500,000 and $2,000,000 amounts are indexed for inflation for taxable years beginning after 2015.

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Qualifying property also includes off-the-shelf computer software and qualified real property (i.e., qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property). Qualifying property excludes any property described in section 50(b) (i.e., certain property not eligible for the investment tax credit).

Passenger automobiles subject to the section 280F limitation are eligible for section 179 expensing only to the extent of the dollar limitations in section 280F. For sport utility vehicles above the 6,000 pound weight rating and not more than the 14,000 pound weight rating, which are not subject to the limitation under section 280F, the maximum cost that may be expensed for any taxable year under section 179 is $25,000 (the “sport utility vehicle limitation”).

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations).

No general business credit under section 38 is allowed with respect to any amount for which a deduction is allowed under section 179. If a corporation makes an election under section 179 to deduct expenditures, the full amount of the deduction does not reduce earnings and profits. Rather, the expenditures that are deducted reduce corporate earnings and profits ratably over a five-year period.

An expensing election is made under rules prescribed by the Secretary. In general, any election or specification made with respect to any property may not be revoked except with the consent of the Commissioner. However, an election or specification under section 179 may be revoked by the taxpayer without consent of the Commissioner.

c) Description of Change

The provision increases the maximum amount a taxpayer may expense under section 179 to $1,000,000, and increases the phase-out threshold amount to $2,500,000. Thus, the provision provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2017, is $1,000,000 of the cost of qualifying property placed in service for the taxable year. The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,500,000. The $1,000,000 and $2,500,000 amounts, as well as the $25,000 sport utility vehicle limitation, are indexed for inflation for taxable years beginning after 2018.

The provision expands the definition of section 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.
The provision also expands the definition of qualified real property eligible for section 179 expensing to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

2. Present State Law

State law, under section 235-2.4(m), HRS, adopts the rules in section 179, IRC, with significant modifications: (1) The aggregate cost provided in section 179(b)(1), which may be taken into account under section 179(a) for any taxable year, shall not exceed $25,000; (2) The amount at which the reduction in limitation provided in section 179(b)(2) begins shall exceed $200,000 for any taxable year; and (3) The following shall not be operative for purposes of Hawaii income tax law: (A) Defining section 179 property to include computer software in section 179(d)(1); (B) Inflation adjustments in section 179(b)(5); (C) Irrevocable election in section 179(c)(2); and (D) Special rules for qualified disaster assistance property in section 179(e).

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to section 179 expensing, meaning that the State would conform to changes in section 179, IRC, but with significant modifications.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to the special rules for farm property in section 168, IRC.

B. Small business accounting method reform and simplification (secs. 263A, 448, 460, and 471 of the Code)

1. Description of Federal Change

   a) Present Law

   (1) General rule for methods of accounting

Section 446 generally allows a taxpayer to select the method of accounting to be used to compute taxable income, provided that such method clearly reflects the income of the taxpayer. The term “method of accounting” includes not only the overall method of accounting used by the taxpayer, but also the accounting treatment of any one item. Permissible overall methods of accounting include the cash receipts and disbursements method (“cash method”), an accrual method, or any other method (including a hybrid method) permitted under regulations prescribed by the Secretary. Examples of any one item for which an accounting method may be adopted include cost recovery, revenue recognition, and timing of deductions. For each separate trade or business, a taxpayer is entitled to adopt any permissible method, subject to certain restrictions.

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for such year. Except as otherwise provided, section 446(e) requires
taxpayers to secure consent of the Secretary before changing a method of accounting. The regulations under this section provide rules for determining: (1) what a method of accounting is, (2) how an adoption of a method of accounting occurs, and (3) how a change in method of accounting is effectuated.

(2) Cash and accrual methods

Taxpayers using the cash method generally recognize items of income when actually or constructively received and items of expense when paid. The cash method is administratively easy and provides the taxpayer flexibility in the timing of income recognition. It is the method generally used by most individual taxpayers, including farm and nonfarm sole proprietorships.

Taxpayers using an accrual method generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred. Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method. The accrual method is often used by businesses for financial accounting purposes.

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method. Exceptions are made for farming businesses, qualified personal service corporations, and the aforementioned entities to the extent their average annual gross receipts do not exceed $5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the “gross receipts test”). The cash method may not be used by any tax shelter. In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor. Such taxpayers generally are required to keep inventories and use an accrual method with respect to inventory items.

A farming business is defined as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees. Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test. However, section 447 generally requires a farming C corporation (and any farming partnership if a corporation is a partner in such partnership) to use an accrual method of accounting. Section 447 does not apply to nursery or sod farms, to the raising or harvesting of trees (other than fruit and nut trees), nor to farming C corporations meeting a gross receipts test with a $1 million threshold. For family farm C corporations, the threshold under the gross receipts test is $25 million.

A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. Qualified personal service corporations are allowed to use the cash method without regard to whether they meet the gross receipts test.
In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is an income-producing factor to the taxpayer. Treasury regulations also provide that in any case in which the use of inventories is necessary to clearly reflect income, the accrual method must be used with regard to purchases and sales. However, an exception is provided for taxpayers whose average annual gross receipts do not exceed $1 million. A second exception is provided for taxpayers in certain industries whose average annual gross receipts do not exceed $10 million and that are not otherwise prohibited from using the cash method under section 448. Such taxpayers may account for inventory as materials and supplies that are not incidental (i.e., “non-incidental materials and supplies”).

In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer’s inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer’s inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the first-in, first-out (“FIFO”) method, which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the last-in, first-out (“LIFO”) method, which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

The uniform capitalization rules require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable. For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

Section 263A provides a number of exceptions to the general uniform capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts; such taxpayers are not required to include additional section 263A costs in inventory. Another exception exists for taxpayers who raise, harvest, or grow trees. Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the uniform capitalization rules do not apply to any plant having a preproductive period of two years or less or to any animal, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)). Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses.
In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method. Under this method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year. The percentage of the contract completed during the taxable year is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs. Costs allocated to the contract typically include all costs (including depreciation) that directly benefit or are incurred by reason of the taxpayer’s long-term contract activities. The allocation of costs to a contract is made in accordance with regulations. Costs incurred with respect to the long-term contract are deductible in the year incurred, subject to general accrual method of accounting principles and limitations.

An exception from the requirement to use the percentage-of-completion method is provided for certain construction contracts (“small construction contracts”). Contracts within this exception are those contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer whose average annual gross receipts for the prior three taxable years do not exceed $10 million. Thus, long-term contract income from small construction contracts must be reported consistently using the taxpayer’s exempt contract method. Permissible exempt contract methods include the completed contract method, the exempt-contract percentage-of-completion method, the percentage-of-completion method, or any other permissible method.

b) Description of Change

The TCJA expands the universe of taxpayers that may use the cash method of accounting. Under the provision, the cash method of accounting may be used by taxpayers, other than tax shelters, that satisfy the gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed $25 million for the three prior taxable-year period (the “$25 million gross receipts test”) to use the cash method. The $25 million amount is indexed for inflation for taxable years beginning after 2018.

The provision expands the universe of farming C corporations (and farming partnerships with a C corporation partner) that may use the cash method to include any farming C corporation (or farming partnership with a C corporation partner) that meets the $25 million gross receipts test.

The provision retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test, so long as the use of such method clearly reflects income.

In addition, the provision also exempts certain taxpayers from the requirement to keep inventories. Specifically, taxpayers that meet the $25 million gross receipts test are not required to account for inventories under section 471, but rather may use a method of accounting for
inventories that either (1) treats inventories as non-incidental materials and supplies, or (2) conforms to the taxpayer’s financial accounting treatment of inventories.

The provision expands the exception for small taxpayers from the uniform capitalization rules. Under the provision, any producer or reseller that meets the $25 million gross receipts test is exempted from the application of section 263A. The provision retains the exemptions from the uniform capitalization rules that are not based on a taxpayer’s gross receipts.

Finally, the provision expands the exception for small construction contracts from the requirement to use the percentage-of-completion method. Under the provision, contracts within this exception are those contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer that (for the taxable year in which the contract was entered into) meets the $25 million gross receipts test.

Under the provision, a taxpayer who fails the $25 million gross receipts test would not be eligible for any of the aforementioned exceptions (i.e., from the accrual method, from keeping inventories, from applying the uniform capitalization rules, or from using the percentage-of-completion method) for such taxable year.

Application of the provisions to expand the universe of taxpayers eligible to use the cash method, exempt certain taxpayers from the requirement to keep inventories, and expand the exception from the uniform capitalization rules is a change in the taxpayer’s method of accounting for purposes of section 481. Application of the exception for small construction contracts from the requirement to use the percentage-of-completion method is applied on a cutoff basis for all similarly classified contracts (hence there is no adjustment under section 481(a) for contracts entered into before January 1, 2018).

Effective date.—The provisions to expand the universe of taxpayers eligible to use the cash method, exempt certain taxpayers from the requirement to keep inventories, and expand the exception from the uniform capitalization rules apply to taxable years beginning after December 31, 2017. The provision to expand the exception for small construction contracts from the requirement to use the percentage-of-completion method applies to contracts entered into after December 31, 2017, in taxable years ending after such date.

2. Present State Law

State law generally conforms to the accounting provisions in IRC sections 263A, 448, 460, and 471.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to the accounting provisions, meaning that the State would conform to the above changes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to the accounting method rules.
C. Modification of treatment of S corporation conversions to C corporations (secs. 481 and 1371 of the Code)

1. Description of Federal Change

a) Present law

Under present law, in the case of an S corporation that converts to a C corporation, distributions of cash by the C corporation to its shareholders during the post-termination transition period (to the extent of the amount in the accumulated adjustment account) are tax-free to the shareholders and reduce the adjusted basis of the stock. The post-termination transition period is generally the one-year period after the S corporation election terminates.

b) Description of Change

Under the TCJA, any section 481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (i.e., a change from the cash method to an accrual method) is taken into account ratably during the six-taxable-year period beginning with the year of change. An eligible terminated S corporation is any C corporation which (1) is an S corporation the day before the enactment of this bill, (2) during the two-year period beginning on the date of such enactment revokes its S corporation election under section 1362(a), and (3) all of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of such enactment.

Under the provision, in the case of a distribution of money by an eligible terminated S corporation, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account bears to the amount the accumulated earnings and profits.

2. Present State Law

State law generally conforms to the provision in IRC section 481.

State law generally conforms to the S corporation rules in section 1371, IRC, as stated in section 235-2.4(h), HRS.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to the S corporation termination provisions, meaning that the State would conform to the above changes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue.

XI. REFORM OF BUSINESS RELATED EXCLUSIONS, DEDUCTIONS, ETC.
A. Interest (sec. 163(j) of the Code)

1. Description of Federal Change
   
a) Present law

   (1) Interest deduction

   Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations.

   Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer’s method of accounting. For all taxpayers, if an obligation is issued with original issue discount (“OID”), a deduction for interest is allowable over the life of the obligation on a yield to maturity basis. Generally, OID arises where interest on a debt instrument is not calculated based on a qualified rate and required to be paid at least annually.

   (2) Investment interest expense

   In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment (“investment interest”) is limited to the taxpayer’s net investment income for the taxable year. Disallowed investment interest is carried forward to the next taxable year.

   Net investment income is investment income net of investment expenses. Investment income generally consists of gross income from property held for investment, and investment expense includes all deductions directly connected with the production of investment income (e.g., deductions for investment management fees) other than deductions for interest.

   The two-percent floor on miscellaneous itemized deductions allows taxpayers to deduct investment expenses connected with investment income only to the extent such deductions exceed two percent of the taxpayer’s adjusted gross income (“AGI”). Miscellaneous itemized deductions that are not investment expenses are disallowed first before any investment expenses are disallowed.

   (3) Earnings stripping

   Section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor’s debt-to-equity ratio exceeds 1.5 to 1.0 (the safe harbor ratio) and the payor’s net interest expense exceeds 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest; (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a real estate investment trust (“REIT”) by a taxable REIT subsidiary of that trust. Interest amounts disallowed under these rules can be carried forward indefinitely. In addition, any excess limitation (i.e., the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor’s net interest expense) can be carried forward three years.
b) Description of change

(1) In general

In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of (1) business interest income; (2) 30 percent of the adjusted taxable income of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year may be carried forward for up to five years beyond the year in which the business interest was paid or accrued, treating business interest as allowed as a deduction on a first-in, first-out basis. The limitation applies at the taxpayer level. In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Internal Revenue Code is interest for purposes of the provision. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of section 163(d).

Adjusted taxable income means the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) any deduction allowable under section 199, and any deduction under section 199A with respect to qualified business income of a passthrough entity. The Secretary may provide other adjustments to the computation of adjusted taxable income.

Floor plan financing interest means interest paid or accrued on floor plan financing indebtedness. Floor plan financing indebtedness means indebtedness used to finance the acquisition of motor vehicles held for sale or lease to retail customers and secured by the inventory so acquired. A motor vehicle means a motor vehicle that is an automobile, a truck, a recreational vehicle, a motorcycle, a boat, or farm machinery or equipment, but does not include construction machinery or equipment.

By including business interest income and floor plan financing interest in the limitation, the rule operates to allow floor plan financing interest to be fully deductible and to limit the deduction for net interest expense (less floor plan financing interest) to 30 percent of adjusted taxable income. That is, a deduction for business interest is permitted to the full extent of business interest income and any floor plan financing interest. To the extent that business interest exceeds business interest income and floor plan financing interest, the deduction for the net interest expense is limited to 30 percent of adjusted taxable income.

It is generally intended that, similar to present law, section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, section 163(j) applies to interest deductions that are deferred, for example under section 163(e) or section 267(a)(3)(B), in the taxable year to which such deductions are deferred.
Section 163(j) applies after section 263A is applied to capitalize interest and after, for example, section 265 or section 279 is applied to disallow interest.

(2) Application to passthrough entities

(a) In general

In the case of any partnership, the limitation is applied at the partnership level. The limit on the amount allowed as a deduction for business interest is increased by a partner’s distributive share of the partnership’s excess taxable income. The excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership’s adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. The TCJA requires that excess taxable income be allocated in the same manner as nonseparately stated income and loss. Similar rules apply with respect to any S corporation and its shareholders.

(b) Double counting rule

The adjusted taxable income of each partner (or shareholder, as the case may be) is determined without regard to such partner’s distributive share of all items of income, gain, deduction, or loss of the partnership when calculating adjusted taxable income or loss of such partnership. In the absence of such a rule, the same dollars of adjusted taxable income of a partnership could generate additional interest deductions as the income is passed through to the partners.

(c) Additional deduction limit

The limit on the amount allowed as a deduction for business interest is increased by a partner’s distributive share of the partnership’s excess amount of unused adjusted taxable income limitation. The excess amount with respect to any partnership is the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership (reduced by floor plan financing interest) exceeds the business interest income of the partnership. This allows a partner of a partnership to deduct more interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest.

c) Carryforward of disallowed business interest

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely. Carryforwards are determined on a first-in, first-out basis. It is intended that the provision be administered in a way to prevent trafficking in carryforwards.
A coordination rule is provided with the limitation on deduction of interest by domestic corporations in international financial reporting groups. Whichever rule imposes the lower limitation on deduction of business interest with respect to the taxable year (and therefore the greatest amount of interest to be carried forward) governs.

Any carryforward of disallowed business interest is an item taken into account in the case of certain corporate acquisitions described in section 381 and is subject to limitation under section 382.

In the case of a partnership, any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership’s excess business interest in any future year, but only against excess taxable income attributed to the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. Additionally, when excess business interest is allocated to a partner, the partner’s basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner’s deduction in a future year for interest carried forward does not reduce the partner’s basis in the partnership interest. In the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner’s basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (i.e., excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). This special rule does not apply to S corporations and their shareholders.

\[\text{d) Exceptions}\]

The limitation does not apply to any taxpayer that meets the $25 million gross receipts test of section 448(c), that is, if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million. Aggregation rules apply to determine the amount of a taxpayer’s gross receipts under the gross receipts test of section 448(c).

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation. As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

The limitation does not apply to a real property trade or business as defined in section 469(c)(7)(C). Any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation. Similarly, at the taxpayer’s election, any farming business, as well as any business engaged in the trade or business of a specified agricultural or horticultural cooperative, are not treated as trades or businesses for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.
The limitation does not apply to certain regulated public utilities. Specifically, the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof is not treated as a trade or business for purposes of the limitation.

2. Present State Law

State law generally conforms to the provision in IRC section 163 regarding interest, with exceptions for section 163(d)(4)(B) defining net investment income to include dividends; and 163(e)(5)(F) and (i)(1) relating to applicable high-yield discount obligation (AHYDO) rules.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to the business interest provisions described above, meaning that the State would conform to the above changes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

B. Modification of net operating loss deduction (sec. 172 of the Code)

1. Description of Federal Change

a) Present Law

A net operating loss (“NOL”) generally means the amount by which a taxpayer’s business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.

Different carryback periods apply with respect to NOLs arising in different circumstances. Extended carryback periods are allowed for NOLs attributable to specified liability losses and certain casualty and disaster losses. Limitations are placed on the carryback of excess interest losses attributable to corporate equity reduction transactions.

b) Federal Change

The TCJA limits the NOL deduction to 80 percent of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation, and may be carried forward indefinitely.
The provision repeals the two-year carryback and the special carryback provisions, but provides a one-year carryback in the case of certain disaster losses incurred in the trade or business of farming, or by certain small businesses. For this purpose, small business means a corporation, partnership, or sole proprietorship whose average annual gross receipts for the three-taxable-year period ending with such taxable year does not exceed $5,000,000. Aggregation rules apply to determine gross receipts.

The TCJA repeals the two-year carryback and the special carryback provisions, but provides a two-year carryback in the case of certain losses incurred in the trade or business of farming. In addition, the TCJA provides a two-year carryback and 20-year carryforward for NOLs of a property and casualty insurance company (defined in section 816(a)) as an insurance company other than a life insurance company). NOLs of a property and casualty insurance company are not subject to the 80% of taxable income limitation.

2. Present State Law

As stated in HRS sections 235-2.4(l) and 235-7(d), state law generally conforms to the provision in IRC section 172 regarding NOLs. State law does not conform to the federal rules on qualified disaster losses.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to the NOL provisions described above, meaning that the State would conform to the above changes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

C. Like-kind exchanges of real property (sec. 1031 of the Code)

1. Description of Federal Change

   a) Present Law

   An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a “like kind” which is to be held for productive use in a trade or business or for investment. In general, section 1031 does not apply to any exchange of stock in trade (i.e., inventory) or other property held primarily for sale; stocks, bonds, or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action. Section 1031 also does not apply to certain exchanges involving or foreign property.

   For purposes of section 1031, the determination of whether property is of a “like kind” relates to the nature or character of the property and not its grade or quality, i.e., the nonrecognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind (e.g., section 1031 does not apply to an exchange of real property for...
personal property). The different classes of property are: (1) depreciable tangible personal property; (2) intangible or nondepreciable personal property; and (3) real property. However, the rules with respect to whether real estate is “like kind” are applied more liberally than the rules governing like-kind exchanges of depreciable, intangible, or nondepreciable personal property. For example, improved real estate and unimproved real estate generally are considered to be property of a “like kind” as this distinction relates to the grade or quality of the real estate, while depreciable tangible personal properties must be either within the same General Asset or within the same Product Class.

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of section 1031, but for the fact that the property received in the transaction consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other non-qualifying property or money (“additional consideration”), then the gain to the recipient of the other property or money is required to be recognized, but not in an amount exceeding the fair market value of such other property or money. Additionally, any such gain realized on a section 1031 exchange as a result of additional consideration being involved constitutes ordinary income to the extent that the gain is subject to the recapture provisions of sections 1245 and 1250. No losses may be recognized from a like-kind exchange.

If section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred. This basis is increased to the extent of any gain recognized as a result of the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer. The holding period of qualifying property received includes the holding period of the qualifying property transferred, but the nonqualifying property received is required to begin a new holding period.

A like-kind exchange also does not require that the properties be exchanged simultaneously. Rather, the property to be received in the exchange must be received not more than 180 days after the date on which the taxpayer relinquishes the original property (but in no event later than the due date (including extensions) of the taxpayer’s income tax return for the taxable year in which the transfer of the relinquished property occurs). In addition, the taxpayer must identify the property to be received within 45 days after the date on which the taxpayer transfers the property relinquished in the exchange.

The Treasury Department has issued regulations and revenue procedures providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges.

b) Federal Change

The TCJA limits like-kind exchanges to real property that is not held primarily for sale.

Effective date.—The provision generally applies to exchanges completed after December 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.
2. Present State Law

State law generally conforms to the provision in IRC section 1031 regarding like-kind exchanges.

The federal rule disallowing like-kind exchange treatment if the replacement property is in a foreign country probably cannot be enforced by a state because of Kraft General Foods, Inc. v. Iowa Department of Revenue and Finance, 505 U.S. 71 (1992).

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to the like-kind exchange provisions described above, meaning that the State would conform to the above changes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

D. Revision of treatment of contributions to capital (sec. 118 of the Code)

1. Description of Federal Change
   a) Present Law

The gross income of a corporation does not include any contribution to its capital. For purposes of this rule, a contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution from a customer or potential customer. A special rule allows certain contributions in aid of construction received by a regulated public utility that provides water or sewerage disposal services to be treated as a tax-free contribution to the capital of the utility. No deduction or credit is allowed for, or by reason of, any expenditure that constitutes a contribution that is treated as a tax-free contribution to the capital of the utility.

If property is acquired by a corporation as a contribution to capital and is not contributed by a shareholder as such, the adjusted basis of the property is zero. If the contribution consists of money, the corporation must first reduce the basis of any property acquired with the contributed money within the following 12-month period, and then reduce the basis of other property held by the corporation. Similarly, the adjusted basis of any property acquired by a utility with a contribution in aid of construction is zero.

b) Federal Change

The TCJA provides that the term “contributions to capital” does not include (1) any contribution in aid of construction or any other contribution as a customer or potential customer, and (2) any contribution by any governmental entity or civic group (other than a contribution made by a shareholder as such). Section 118, as modified, will continue to apply only to corporations.
Effective date.—The provision applies to contributions made after the date of enactment. However, the provision shall not apply to any contribution made after the date of enactment by a governmental entity pursuant to a master development plan that has been approved prior to such date by a governmental entity.

2. Present State Law

State law generally conforms to the provision in IRC section 118 regarding nonshareholder capital contributions.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to the nonshareholder capital contribution provisions described above, meaning that the State would conform to the above changes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

E. Repeal of deduction for local lobbying expenses (sec. 162(e) of the Code)

1. Description of Federal Change
   a) Present Law in General

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. However, section 162(e) denies a deduction for amounts paid or incurred in connection with (1) influencing legislation, (2) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office, (3) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or (4) any direct communication with a covered executive branch official in an attempt to influence the official actions or positions of such official. Expenses paid or incurred in connection with lobbying and political activities (such as research for, or preparation, planning, or coordination of, any previously described activity) also are not deductible.

b) Exception for Local legislation

Notwithstanding the above, a deduction is allowed for ordinary and necessary expenses incurred in connection with any legislation of any local council or similar governing body (“local legislation”). With respect to local legislation, the exception permits a deduction for amounts paid or incurred in carrying on any trade or business (1) in direct connection with appearances before, submission of statements to, or sending communications to the committees or individual members of such council or body with respect to legislation or proposed legislation of direct interest to the taxpayer, or (2) in direct connection with communication of information between the taxpayer and an organization of which the taxpayer is a member with
respect to any such legislation or proposed legislation which is of direct interest to the taxpayer and such organization, and (3) that portion of the dues paid or incurred with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities described in (1) or (2) carried on by such organization.

For purposes of this exception, legislation of an Indian tribal government is treated in the same manner as local legislation.

c) De minimis exception

For taxpayers with $2,000 or less of in-house expenditures related to lobbying and political activities, a de minimis exception is provided that permits a deduction.

d) Federal Change

The TCJA repeals the exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian tribal governments. Thus, the general disallowance rules applicable to lobbying and political expenditures will apply to costs incurred related to such local legislation.

Effective date.—The provision applies to amounts paid or incurred on or after the date of enactment.

2. Present State Law

State law generally conforms to the provision in IRC section 162(e) regarding nondeductibility of lobbying expenses.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to nondeductibility of lobbying expenses, meaning that the State would conform to the above changes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

F. Repeal of deduction for income attributable to domestic production activities (sec. 199 of the Code)

1. Description of Federal Change

   a) Present Law in General

Section 199 provides a deduction from taxable income (or, in the case of an individual, adjusted gross income) that is equal to nine percent of the lesser of the taxpayer’s qualified production activities income or taxable income (determined without regard to the section 199 deduction) for the taxable year. For corporations subject to the 35-percent corporate income tax
rate, the nine-percent deduction effectively reduces the corporate income tax rate to slightly less than 32 percent on qualified production activities income. A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film produced by the taxpayer; any sale, exchange, or other disposition, or any lease, rental, or license, of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

The amount of the deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.

b) Federal Change

The TCJA repeals the deduction for income attributable to domestic production activities.

2. Present State Law

State law, in section 235-2.3(b)(15), HRS, has not adopted the domestic production activities deduction.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to the domestic production activities deduction, meaning that the deduction would be inoperative for State purposes.

4. Comments of the Tax Foundation of Hawaii

The change in the federal code conforms federal law to Hawaii law. We recommend no state change to avoid further complexity and unintended consequences.

G. Entertainment, etc. expenses (sec. 274 of the Code)

1. Description of Federal Change
   a) Present Law in General
No deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation ("entertainment"), unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer’s trade or business, or (2) a facility (e.g., an airplane) used in connection with such activity. If the taxpayer establishes that entertainment expenses are directly related to (or associated with) the active conduct of its trade or business, the deduction generally is limited to 50 percent of the amount otherwise deductible. Similarly, a deduction for any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible. In addition, no deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation, or other social purpose.

There are a number of exceptions to the general rule disallowing deduction of entertainment expenses and the rules limiting deductions to 50 percent of the otherwise deductible amount. Under one such exception, those rules do not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and as wages to an employee. Those rules also do not apply to expenses for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (e.g., a nonemployee director) as compensation for services rendered or as a prize or award. The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the taxpayer’s actual cost, even if a greater amount (i.e., fair market value) is includible in income.

Those deduction disallowance rules also do not apply to expenses paid or incurred by the taxpayer, in connection with the performance of services for another person (other than an employer), under a reimbursement or other expense allowance arrangement if the taxpayer accounts for the expenses to such person. Another exception applies for expenses for recreational, social, or similar activities primarily for the benefit of employees other than certain owners and highly compensated employees. An exception applies also to the 50 percent deduction limit for food and beverages provided to crew members of certain commercial vessels and certain oil or gas platform or drilling rig workers.

b) Expenses treated as compensation

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. In general, an employee (or other service provider) must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount (if any) paid by the individual and the amount (if any) specifically excluded from gross income. Treasury regulations provide detailed rules regarding the valuation of certain fringe benefits, including flights on an employer-provided aircraft. In general, the value of a non-commercial flight generally is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula or “SIFL.” If the SIFL valuation rules do not apply, the value of a flight on an employer-provided aircraft generally is equal to the amount that an individual would have to pay in an arm’s-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.
In the context of an employer providing an aircraft to employees for nonbusiness (e.g., vacation) flights, the exception for expenses treated as compensation has been interpreted as not limiting the company’s deduction for expenses attributable to the operation of the aircraft to the amount of compensation reportable to its employees. The result of that interpretation is often a deduction several times larger than the amount required to be included in income. Further, in many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

The exceptions for expenses treated as compensation or otherwise includible income were subsequently modified in the case of specified individuals such that the exceptions apply only to the extent of the amount of expenses treated as compensation or includible in income of the specified individual. Specified individuals are individuals who, with respect to an employer or other service recipient (or a related party), are subject to the requirements of section 16(a) of the Securities Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient (or related party) were an issuer of equity securities referred to in section 16(a).

As a result, in the case of specified individuals, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (e.g., an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income to the specified individual. For example, a company’s deduction attributable to aircraft operating costs and other expenses for a specified individual’s vacation use of a company aircraft is limited to the amount reported as compensation to the specified individual. However, in the case of other employees or service providers, the company’s deduction is not limited to the amount treated as compensation or includible in income.

c) Excludable fringe benefits

Certain employer-provided fringe benefits are excluded from an employee’s gross income and wages for employment tax purposes, including, but not limited to, de minimis fringes, qualified transportation fringes, on-premises athletic facilities, and meals provided for the “convenience of the employer.”

A de minimis fringe generally means any property or service the value of which is (taking into account the frequency with which similar fringes are provided by the employer) so small as to make accounting for it unreasonable or administratively impracticable, and also includes food and beverages provided to employees through an eating facility operated by the employer that is located on or near the employer’s business premises and meets certain requirements.

Qualified transportation fringes include qualified parking (parking on or near the employer’s business premises or on or near a location from which the employee commutes to work by public transit), transit passes, vanpool benefits, and qualified bicycle commuting reimbursements.
On-premises athletic facilities are gyms or other athletic facilities located on the employer’s premises, operated by the employer, and substantially all the use of which is by employees of the employer, their spouses, and their dependent children.

The value of meals furnished to an employee or the employee’s spouse or dependents by or on behalf of an employer for the convenience of the employer is excludible from the employee’s gross income, but only if such meals are provided on the employer’s business premises.

d) Federal Change

The TCJA provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items. Thus, the provision repeals the present-law exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer’s trade or business (and the related rule applying a 50 percent limit to such deductions).

In addition, the provision disallows a deduction for expenses associated with providing any qualified transportation fringe to employees of the taxpayer, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee’s residence and place of employment.

Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (e.g., meals consumed by employees on work travel). For amounts incurred and paid after December 31, 2017 and until December 31, 2025, the provision expands this 50 percent limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for de minimis fringes and for the convenience of the employer.

2. Present State Law

State law generally conforms to the provision in IRC section 274 regarding business meals and entertainment deductions.

3. Proposal in SB 2821, SD-1

The bill proposes to decouple from the federal changes to section 274, IRC, and allow deduction of such expenses for state purposes, in proposed HRS section 235-2.4(t), by conforming state law to the Code as it existed before enactment of the TCJA.

4. Comments of the Tax Foundation of Hawaii

We recommend conformity on this issue to avoid further complexity and unintended consequences.
H. Repeal of exclusion, etc., for employee achievement awards (secs. 74(c) and 274(j) of the Code)

1. Description of Federal Change

   a) Present Law

   An employer’s deduction for the cost of an employee achievement award is limited to a certain amount. Employee achievement awards that are deductible by an employer (or would be deductible but for the fact that the employer is a tax-exempt organization) are excludible from an employee’s gross income. Amounts that are excludible from gross income under section 74(c) for income tax purposes are also excluded from wages for employment tax purposes.

   An employee achievement award is an item of tangible personal property given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation.

   b) Federal Change

   The TCJA adds a definition of “tangible personal property” that may be considered a deductible employee achievement award. It provides that tangible personal property shall not include cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. No inference is intended that this is a change from present law and guidance.

2. Present State Law

   State law generally conforms to the provision in IRC section 74 regarding exclusion of qualifying achievement awards from an employee’s income.

   State law generally conforms to the provision in IRC section 274 regarding business meals and entertainment deductions.

3. Proposal in SB 2821, SD-1

   The bill does not propose any changes relating to section 74, IRC, meaning that any change would be operative for State purposes.

   The bill proposes to decouple from the federal changes to section 274, IRC, and allow deduction of such expenses for state purposes, in proposed HRS section 235-2.4(t), by conforming state law to the Code as it existed before enactment of the TCJA.

4. Comments of the Tax Foundation of Hawaii
The federal change is a technical clarification of the treatment of employee achievement awards. We recommend conformity on this issue to avoid further complexity and unintended consequences.

I. Unrelated business taxable income increased by amount of certain fringe benefit expenses for which deduction is disallowed (sec. 512 of the Code)

1. Description of Federal Change

   a) Tax exemption for certain organizations

   Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

   b) Unrelated business income tax, in general

   The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt functions. An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

   Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing its exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities. Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

   An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business. Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions. As a result, an organization may use a loss from one unrelated trade or business to offset gain from another, thereby reducing total unrelated business taxable income.

   c) Organizations subject to tax on unrelated business income

   Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts); (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a); and (3) certain State colleges and universities.
d) Exclusions from Unrelated Business Taxable Income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries. Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

e) Federal change

Under the TCJA, unrelated business taxable income includes any expenses paid or incurred by a tax exempt organization for qualified transportation fringe benefits (as defined in section 132(f)), a parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or any on-premises athletic facility (as defined in section 132(j)(4)(B)), provided such amounts are not deductible under section 274.

2. Present State Law

State law generally conforms to the provisions in IRC sections 512 to 514 regarding the determination of UBIT, except that state law, under HRS section 235-2.4(aa), provides for different methodology for determining what income is considered within the state and subject to state income tax, and it also provides that the UBIT tax rates are those generally provided for corporations and individuals.

State law generally conforms to the provisions in IRC section 132, under HRS section 235-2.4(g).

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to UBIT or to parking expense reimbursements.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.
J. Limitation on deduction for FDIC premiums (sec. 162 of the Code)
   1. Description of Federal Change
      a) Corporate taxation generally

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation generally comprises gross income less allowable deductions. A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.

Corporations that make a valid election pursuant to section 1362 of subchapter S of the Code, referred to as S corporations, generally are not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns.

b) Banks, thrifts, and credit unions
   (1) In general

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with specified exceptions.

   (2) C corporation banks and thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers. A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.

   (3) S corporation banks

A bank is generally eligible to elect S corporation status under section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in section 585.

   (4) Special bad debt loss rules for small banks

Section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. The reserve method of accounting for bad debts, repealed in for most taxpayers, is allowed under section 585 for any bank (as defined in section 581) other than a large bank. For this purpose, a bank is a large bank if, for the taxable year (or for any preceding taxable year after 1986), the average adjusted basis of all its assets (or the assets of the controlled group of which it is a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that generally looks to the ratio of (1) the total bad debts sustained
during the taxable year and the five preceding taxable years to (2) the sum of the loans
outstanding at the close of such taxable years.

(5) Credit unions

Credit unions are exempt from Federal income taxation. The exemption is based on their
status as not-for-profit mutual or cooperative organizations (without capital stock) operated for
the benefit of their members, who generally must share a common bond. The definition of
common bond has been expanded to permit greater use of credit unions. While significant
differences between the rules under which credit unions and banks operate have existed in the
past, most of those differences have disappeared over time.

(6) FDIC premiums

The Federal Deposit Insurance Corporation (“FDIC”) provides deposit insurance for
banks and savings institutions. To maintain its status as an insured depository institution, a bank
must pay semiannual assessments into the deposit insurance fund (“DIF”). Assessments for
deposit insurance are treated as ordinary and necessary business expenses. These assessments,
also known as premiums, are deductible once the all events test for the premium is satisfied.

c) Description of Change

No deduction is allowed for the applicable percentage of any FDIC premium paid or
incurred by the taxpayer. For taxpayers with total consolidated assets of $50 billion or more, the
applicable percentage is 100 percent. Otherwise, the applicable percentage is the ratio of the
excess of total consolidated assets over $10 billion to $40 billion. For example, for a taxpayer
with total consolidated assets of $20 billion, no deduction is allowed for 25 percent of FDIC
premiums. The provision does not apply to taxpayers with total consolidated assets (as of the
close of the taxable year) that do not exceed $10 billion.

FDIC premium means any assessment imposed under section 7(b) of the Federal
Deposit Insurance Act. The term total consolidated assets has the meaning given such term
under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

For purposes of determining a taxpayer’s total consolidated assets, members of an
expanded affiliated group are treated as a single taxpayer. An expanded affiliated group means
an affiliated group as defined in section 1504(a), determined by substituting “more than 50
percent” for “at least 80 percent” each place it appears and without regard to the exceptions
from the definition of includible corporation for insurance companies and foreign corporations.
A partnership or any other entity other than a corporation is treated as a member of an expanded
affiliated group if such entity is controlled by members of such group.

2. Present State Law

State law generally conforms to the provisions in IRC section 162, relating to business
deductions.
3. **Proposal in SB 2821, SD-1**

The bill does not propose any changes relating to deductibility of FDIC premiums, meaning that any change would be operative for State purposes.

4. **Comments of the Tax Foundation of Hawaii**

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

K. **Repeal of rollover of publicly traded securities gain into specialized small business investment companies (sec. 1044 of the Code)**

1. **Description of Federal Change**

A corporation or individual may elect to roll over tax-free any capital gain realized on the sale of publicly-traded securities to the extent of the taxpayer’s cost of purchasing common stock or a partnership interest in a specialized small business investment company within 60 days of the sale. The amount of gain that an individual may elect to roll over under this provision for a taxable year is limited to (1) $50,000 or (2) $500,000 reduced by the gain previously excluded under this provision. For corporations, these limits are $250,000 and $1 million, respectively.

The TCJA repeals the election described above to roll over tax-free capital gain realized on the sale of publicly-traded securities.

2. **Present State Law**

State law generally conforms to the provisions in IRC section 1044 described above.

3. **Proposal in SB 2821, SD-1**

The bill does not propose any changes relating to section 1044, IRC, meaning that any change would be operative for State purposes.

4. **Comments of the Tax Foundation of Hawaii**

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

L. **Certain self-created property not treated as a capital asset (sec. 1221 of the Code)**

1. **Description of Federal Change**

   a) **Present Law**

In general, property held by a taxpayer (whether or not connected with his trade or business) is considered a capital asset. Certain assets, however, are specifically excluded from
the definition of capital asset. Such excluded assets are: inventory property, property of a character subject to depreciation (including real property), certain self-created intangibles, accounts or notes receivable acquired in the ordinary course of business (e.g., for providing services or selling property), publications of the U.S. Government received by a taxpayer other than by purchase at the price offered to the public, commodities derivative financial instruments held by a commodities derivatives dealer unless established to the satisfaction of the Secretary that any such instrument has no connection to the activities of such dealer as a dealer and clearly identified as such before the close of the day on which it was acquired, originated, or entered into, hedging transactions clearly identified as such, and supplies regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

Self-created intangibles subject to the exception are copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property which is held either by the taxpayer who created the property, or (in the case of a letter, memorandum, or similar property) a taxpayer for whom the property was produced. For the purpose of determining gain, a taxpayer with a substituted or transferred basis from the taxpayer who created the property, or for whom the property was created, also is subject to the exception. However, a taxpayer may elect to treat musical compositions and copyrights in musical works as capital assets.

Since the intent of Congress is that profits and losses arising from everyday business operations be characterized as ordinary income and loss, the general definition of capital asset is narrowly applied and the categories of exclusions are broadly interpreted.

b) Federal change

The TCJA amends section 1221(a)(3), resulting in the exclusion of a patent, invention, model or design (whether or not patented), and a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) from the definition of a “capital asset.” Thus, gains or losses from the sale or exchange of a patent, invention, model or design (whether or not patented), or a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will not receive capital gain treatment.

2. Present State Law

State law generally conforms to the provisions in IRC section 1221 described above. See section 235-2.4(g), HRS.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to section 1221, IRC, relating to self-created property, meaning that any change would be operative for State purposes.

4. Comments of the Tax Foundation of Hawaii
We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

M. Repeal of special rule for sale or exchange of patents (sec. 1235 of the Code)

1. Description of Federal Change

Section 1235 provides that a transfer of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights, by any holder shall be considered the sale or exchange of a capital asset held for more than one year, regardless of whether or not payments in consideration of such transfer are (1) payable periodically over a period generally conterminous with the transferee’s use of the patent, or (2) contingent on the productivity, use, or disposition of the property transferred.

A holder is defined as (1) any individual whose efforts created such property, or (2) any other individual who has acquired his interest in such property in exchange for consideration in money or money’s worth paid to such creator prior to actual reduction to practice of the invention covered by the patent, if such individual is neither the employer of such creator nor related (as defined) to such creator.

The TCJA repeals section 1235. Thus, the holder of a patented invention may not transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset. It is intended that the determination of whether a transfer is a sale or exchange of a capital asset that produces capital gain, or a transaction that produces ordinary income, will be determined under generally applicable principles.

2. Present State Law

State law generally conforms to the provisions in IRC section 1235.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to section 1235, IRC, meaning that any change would be operative for State purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

N. Repeal of technical termination of partnerships (sec. 708(b) of the Code)

1. Description of Federal Change

A partnership is considered as terminated under specified circumstances. Special rules apply in the case of the merger, consolidation, or division of a partnership.
A partnership is treated as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

A partnership is also treated as terminated if within any 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits. This is sometimes referred to as a technical termination. Under regulations, the technical termination gives rise to a deemed contribution of all the partnership’s assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.

The effect of a technical termination is not necessarily the end of the partnership’s existence, but rather the termination of some tax attributes. Upon a technical termination, the partnership’s taxable year closes, potentially resulting in short taxable years. Partnership-level elections generally cease to apply following a technical termination. A technical termination generally results in the restart of partnership depreciation recovery periods.

The TCJA repeals the section 708(b)(1)(B) rule providing for technical terminations of partnerships. The provision does not change the present-law rule of section 708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

Effective date.—The provision applies to partnership taxable years beginning after December 31, 2017.

2. Present State Law

State law generally conforms to the provisions in IRC section 708.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to section 708, IRC, meaning that any change would be operative for State purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

O. Recharacterization of certain gains in the case of partnership profits interests held in connection with performance of investment services (secs. 1061 and 83 of the Code)

1. Description of Federal Change
   a) Partnership profits interest for services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate
liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest.

In 1993, the Internal Revenue Service, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profits interest for services as not a taxable event for the partnership or the partner. Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance clarifies that this treatment applies with respect to substantially unvested profits interests provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.

By contrast, a partnership capital interest received for services is includable in the partner’s income under generally applicable rules relating to the receipt of property for the performance of services. A partnership capital interest for this purpose is an interest that would entitle the receiving partner to a share of the proceeds if the partnership’s assets were sold at fair market value and the proceeds were distributed in liquidation.

b) Property received for services under section 83

(1) In general

Section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the “service provider”) generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture). The amount includible in the service provider’s income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the “service recipient”) equal to the amount included in gross income by the service provider. The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider’s income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as “substantially nonvested.” Property is subject to a substantial risk of forfeiture if the individual’s right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.
(2) Section 83(b) election

Under section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a “section 83(b) election.” The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

c) Passthrough tax treatment of partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners. Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates. A partner’s basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership’s tax status as a passthrough entity. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner’s basis in the partnership interest.

d) Net long-term capital gain

In the case of an individual, estate, or trust, any adjusted net capital gain which otherwise would be taxed at the 10- or 15-percent rate is not taxed. Any adjusted net capital gain which otherwise would be taxed at rates over 15 percent and below 39.6 percent is taxed at a 15-percent rate. Any adjusted net capital gain which otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate.

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income.

Short-term capital gain means gain from the sale or exchange of a capital asset held for not more than one year, if and to the extent such gain is taken into account in computing gross income. Net short-term capital loss means the excess of short-term capital losses for the taxable year over the short-term capital gains for the taxable year.

Net long-term capital gain means the excess of long-term capital gains for the taxable year over the long-term capital losses for the taxable year.

Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.
The adjusted net capital gain of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation.

\[ e) \quad \text{Federal Change} \]

\[ (1) \quad \text{General rule} \]

The TCJA provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer.

The provision’s three-year holding requirement applies notwithstanding the rules of section 83 or any election in effect under section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest. Thus, the provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer’s net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

\[ (2) \quad \text{Short-term capital gain} \]

A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. Third party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged). A related person for this purpose is a family member (within the meaning of attribution) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

\[ (3) \quad \text{Applicable partnership interest} \]

An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The services may be performed by the taxpayer or by any other related person or persons in any applicable trade or business. It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the Treasury Department is directed to provide guidance implementing this intent. An applicable partnership interest does not include an interest held by a person who is
employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.

An applicable partnership interest does not include an interest in a partnership directly or indirectly held by a corporation. For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests.

An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner’s share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

(4) Applicable trade or business

An applicable trade or business means any activity (regardless of whether the activity is conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets.

Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.

(5) Specified assets

Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership’s proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether section 1256 applies to the contract), and (6) position that is not such a security and
is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.

A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.

(6) Transfer of applicable partnership interest to related person

If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income as short-term capital gain so much of the taxpayer’s net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted). A related person for this purpose is a family member (within the meaning of attribution rules) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

(7) Reporting requirement

The Secretary is directed to require reporting (at the time in the manner determined by the Secretary) necessary to carry out the purposes of the provision. The penalties otherwise applicable to a failure to report to partners under section 6031(b) apply to failure to report under this requirement.

(8) Regulatory authority

The Treasury Department is directed to issue regulations or other guidance necessary to carry out the provision. Such guidance is to address prevention of the abuse of the purposes of the provision, including through the allocation of income to tax-indifferent parties. Guidance is also to provide for the application of the provision in the case of tiered structures of entities.

2. Present State Law

State law generally conforms to the provisions in IRC sections 83 and 1061.

3. Proposal in SB 2821, SD-1
The bill does not propose any changes relating to sections 83 and 1061, IRC, meaning that the federal changes would be operative for State purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

P. Amortization of research and experimental expenditures (sec. 174 of the Code)

1. Description of Federal Change
   a) Present Law

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life. Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business. Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months. Taxpayers, alternatively, may elect to amortize their research expenditures over a period of 10 years. Research and experimental expenditures deductible under section 174 are not subject to capitalization under either section 263(a) or section 263A.

Amounts defined as research or experimental expenditures under section 174 generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product. In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product. Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product. The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (e.g., utilities, depreciation, rent), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials). In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to research expenditures.

Research or experimental expenditures under section 174 do not include expenditures for quality control testing; efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another’s patent, model, production or process; or research in connection with literary, historical, or similar projects. For purposes of section 174, quality control testing means testing to determine whether particular units of materials or products conform to specified parameters, but does not include testing to determine if the design of the product is appropriate.
Generally, no current deduction under section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation. In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.

b) Description of Change

Under the TCJA, amounts defined as specified research or experimental expenditures are required to be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred. Specified research or experimental expenditures which are attributable to research that is conducted outside of the United States are required to be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the taxable year in which such expenditures were paid or incurred. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

Specified research or experimental expenditures do not include expenditures for land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of such property. Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).

In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

As part of the repeal of the alternative minimum tax, taxpayers may no longer elect to amortize their research or experimental expenditures over a period of 10 years.

The application of this provision is treated as a change in the taxpayer’s method of accounting for purposes of section 481, initiated by the taxpayer, and made with the consent of the Secretary. The provision is applied on a cutoff basis to research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021 (hence there is no adjustment under section 481(a) for research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2022). In addition, conforming changes are made to sections 41 and 280C.

Effective date.—The provision applies to amounts paid or incurred in taxable years beginning after December 31, 2021.

2. Present State Law

State law generally conforms to the provisions in IRC section 174.

3. Proposal in SB 2821, SD-1
The bill does not propose any changes relating to section 174, IRC, meaning that the federal changes would be operative for State purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

Q. Certain special rules for taxable year of inclusion (sec. 451 of the Code)
   1. Description of Federal Change
      a) Present Law on Income Inclusion

Under section 61(a), IRC, gross income generally includes all income from whatever source derived, except as otherwise provided in Subtitle A of the Code. Thus, gross income generally includes income realized in any form, whether in money, property, or services, except to the extent provided in other sections of the Code. Once it is determined that an item of gross income is clearly realized for Federal income tax purposes, section 451 and the regulations thereunder provide the general rules as to the timing of when such item is to be included in gross income.

A taxpayer generally is required to include an item in gross income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer’s method of accounting. If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount whether or not the taxpayer makes the demand and actually receives the payment.

In general, for a cash basis taxpayer, an amount is included in gross income when actually or constructively received. For an accrual basis taxpayer, an amount is included in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (i.e., when the “all events test” is met), unless an exception permits deferral or exclusion, or a special method of accounting applies.

A number of exceptions that exist to permit deferral of gross income relate to advance payments. An advance payment is when a taxpayer receives payment before the taxpayer provides goods or services to its customer. The exceptions often allow tax deferral to mirror financial accounting deferral (e.g., income is recognized as the goods are provided or the services are performed).

b) Interest income

A taxpayer generally must include in gross income the amount of interest received or accrued within the taxable year on indebtedness held by the taxpayer.

c) Original issue discount
The holder of a debt instrument with original issue discount ("OID") generally accrues and includes the OID in gross income as interest over the term of the instrument, regardless of when the stated interest (if any) is paid.

The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument. The stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments. The holder includes in gross income an amount equal to the sum of the daily portions of the OID for each day during the taxable year the holder held such debt instrument. The daily portion is determined by allocating to each day in any accrual period its ratable portion of the increase during such accrual period in the adjusted issue price of the debt instrument. The adjustment to the issue price is determined by multiplying the adjusted issue price (i.e., the issue price increased by adjustments prior to the accrual period) by the instrument’s yield to maturity, and then subtracting the interest payable during the accrual period. Thus, to compute the amount of OID and the portion of OID allocable to a period, the stated redemption price at maturity and the term must be known. Issuers of OID instruments accrue and deduct the amount of OID as interest expense in the same manner as the holder.

d) Debt instruments subject to acceleration

Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. If a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt.84 In addition, in the case of (1) any regular interest in a real estate mortgage investment conduit ("REMIC") or qualified mortgages held by a REMIC or (2) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are determined by taking into account an assumption regarding the prepayment of principal for such instruments.

The Taxpayer Relief Act of extended these rules to any pool of debt instruments the payments on which may be accelerated by reason of prepayments. Thus, if a taxpayer holds a pool of credit card receivables that require interest to be paid only if the borrowers do not pay their accounts by a specified date ("grace-period interest"), the taxpayer is required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. Under these rules, certain amounts (other than grace-period interest) related to credit card transactions, such as late-payment fees, cash-advance fees, and interchange fees, have been determined to create OID or increase the amount of OID on the pool of credit card receivables to which the amounts relate.

e) Description of Federal Change

The provision revises the rules associated with the timing of the recognition of income. Specifically, the provision requires an accrual method taxpayer subject to the all events test for an item of gross income to recognize such income no later than the taxable year in which such income is taken into account as revenue in an applicable financial or another financial statement under rules specified by the Secretary, but provides an exception for taxpayers without an applicable or other specified financial statement. In the case of a contract which contains
multiple performance obligations, the provision allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer’s applicable financial statement.

In addition, the provision directs accrual method taxpayers with an applicable financial statement to apply the income recognition rules under section 451 before applying the special rules under part V of subchapter P, which, in addition to the OID rules, also includes rules regarding the treatment of market discount on bonds, discounts on short-term obligations, OID on tax-exempt bonds, and stripped bonds and stripped coupons. Thus, for example, to the extent amounts are included in revenue for financial statement purposes when received (e.g., late-payment fees, cash-advance fees, or interchange fees), such amounts generally are includable in income at such time in accordance with the general recognition principles under section 451. The provision provides an exception for any item of gross income in connection with a mortgage servicing contract. Thus, under the provision, income from mortgage servicing rights will continue to be recognized in accordance with the present law rules for such items of gross income (i.e., “normal” mortgage servicing rights will be included in income upon the earlier of earned or received under the all events test of section 451 (i.e., not averaged over the life of the mortgage),876 and “excess” mortgage servicing rights will be treated as stripped coupons under section 1286 and therefore subject to the original issue discount).

The provision also codifies the current deferral method of accounting for advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004-34. That is, the provision allows accrual method taxpayers to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes. In the case of advance payments received for a combination of services, goods, or other specified items, the provision allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer’s applicable financial statement. The provision requires the inclusion in gross income of a deferred advance payment if the taxpayer ceases to exist.

The application of these rules is a change in the taxpayer’s method of accounting for purposes of section 481. In the case of any taxpayer required by this provision to change its method of accounting for its first taxable year beginning after December 31, 2017, such change is treated as initiated by the taxpayer and made with the consent of the Secretary. In the case of income from a debt instrument having OID, the related section 481(a) adjustment is taken into account over six taxable years.

2. Present State Law

State law generally conforms to the provisions in IRC section 451 relating to original issue discount. Under HRS section 235-2.4(w), only section 451(i)(3) and (6), as it relates to a qualified electric utility, are not in effect for Hawaii law.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to section 451, IRC, meaning that the federal changes would be operative for State purposes.
4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

R. Denial of deduction for certain fines, penalties, and other amounts (sec. 162(f) and new sec. 6050X of the Code)

1. Description of Federal Change

a) Present Law

The Code denies a deduction for fines or penalties paid to a government for the violation of any law.

b) Description of change

The provision denies deductibility for any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. In the case of any amount of restitution for failure to pay any tax and assessed as restitution under the Code, such restitution is deductible only to the extent it would have been allowed as a deduction if it had been timely paid. The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made. Restitution or included remediation of property does not include reimbursement of government investigative or litigation costs.

The provision applies only where a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law. An exception also applies to any amount paid or incurred as taxes due.

The provision requires government agencies (or entities treated as such agencies under the provision) to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by the Secretary of the Treasury.

Effective date.—The provision denying the deduction and the reporting provision are effective for amounts paid or incurred on or after the date of enactment, except that it would not apply to amounts paid or incurred under any binding order or agreement entered into before
such date. Such exception does not apply to an order or agreement requiring court approval unless the approval was obtained before such date.

2. **Present State Law**

State law generally conforms to the provisions in IRC section 162(f) relating to fines and penalties.

3. **Proposal in SB 2821, SD-1**

The bill does not propose any changes relating to section 162, IRC, meaning that the federal changes would be operative for State purposes.

4. **Comments of the Tax Foundation of Hawaii**

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

5. **Denial of deduction for settlements subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse (new sec. 162(q) of the Code)**

   1. **Description of Federal Change**

      a) **Present Law**

      A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business. However, certain exceptions apply. No deduction is allowed for (1) any charitable contribution or gift that would be allowable as a deduction under section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section; (2) any illegal bribe, illegal kickback, or other illegal payment; (3) certain lobbying and political expenditures; (4) any fine or similar penalty paid to a government for the violation of any law; (5) two-thirds of treble damage payments under the antitrust laws; (6) certain foreign advertising expenses; (7) certain amounts paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person; or (8) certain applicable employee remuneration.

      b) **Description of federal change**

      Under the TCJA, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

      Effective date.—The provision is effective for amounts paid or incurred after the date of enactment.

XII. **REFORM OF BUSINESS CREDITS**
A. Modification of credit for clinical testing expenses for certain drugs for rare diseases or conditions (sec. 45C of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

   Federal credits are generally inoperative for State income tax purposes under section 235-2.3(b)(1), HRS. This is because state law provides its own set of credits.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state treatment of the credit. Federal changes will not be operative for State income tax purposes.

   4. Comments of the Tax Foundation of Hawaii

   Traditionally, state law provides its own set of credits so there is no need to conform with federal credit provisions.

B. Rehabilitation credit for certified historic structure (sec. 47 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

   Federal credits are generally inoperative for State income tax purposes under section 235-2.3(b)(1), HRS. This is because state law provides its own set of credits.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state treatment of the credit. Federal changes will not be operative for State income tax purposes.

   4. Comments of the Tax Foundation of Hawaii

   Traditionally, state law provides its own set of credits so there is no need to conform with federal credit provisions.

C. Employer credit for paid family and medical leave (new sec. 45S of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

   Federal credits are generally inoperative for State income tax purposes under section 235-2.3(b)(1), HRS. This is because state law provides its own set of credits.
3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment of the credit. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Traditionally, state law provides its own set of credits so there is no need to conform with federal credit provisions.

D. Repeal of advance refunding bonds (sec. 149(d) of the Code)

1. Description of Federal Change

   a) Present Law

   Section 103 generally provides that gross income does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (e.g., private businesses or individuals). Bonds issued to finance the activities of charitable organizations described in section 501(c)(3) (“qualified 501(c)(3) bonds”) are one type of private activity bond. The exclusion from income for interest on State and local bonds only applies if certain Code requirements are met.

   The exclusion for income for interest on State and local bonds applies to refunding bonds but there are limits on advance refunding bonds. A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond). Different rules apply to current as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond. Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

   Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the Code limits advance refundings. Generally, governmental bonds and qualified 501(c)(3) bonds may be advance refunded one time. Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all. Furthermore, in the case of an advance refunding bond that results in interest savings (e.g., a high interest rate to low interest rate refunding), the refunded bond must be redeemed on the first call date 90 days after the issuance of the refunding bond that results in debt service savings.

   b) Federal Change

   The TCJA repeals the exclusion from gross income for interest on a bond issued to advance refund another bond.
Effective date.—The provision applies to advance refunding bonds issued after December 31, 2017.

2. Present State Law

State law conforms to section 149, IRC.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to section 149, IRC.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to the rules for capitalization in section 263A, IRC.

E. Repeal of tax credit bonds (secs. 54A, 54B, 54C, 54D, 54E, 54F and 6431 of the Code)

1. Description of Federal Change
   a) Present Law in general

   Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current tax-credit bonds include qualified tax credit bonds, which have certain common general requirements, and include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds.

   b) Qualified tax-credit bonds
      (1) General rules applicable to qualified tax-credit bonds

      Unlike tax-exempt bonds, qualified tax-credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax-credit bond on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond’s credit rate by the face amount on the holder’s bond. The credit rate for an issue of qualified tax credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax-credit bonds without discount and interest cost to the qualified issuer. The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

      (2) New clean renewable energy bonds
New clean renewable energy bonds (“New CREBs”) may be issued by qualified issuers to finance qualified renewable energy facilities. Qualified renewable energy facilities are facilities that: (1) qualify for the tax credit under section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) are owned by a public power provider, governmental body, or cooperative electric company.

The term “qualified issuers” includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (5) clean renewable energy bond lenders. There was originally a national limitation for New CREBs of $800 million. The national limitation was then increased by an additional $1.6 billion in 2009. As with other tax credit bonds, a taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. However, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.

(3) Qualified energy conservation bonds

Qualified energy conservation bonds may be used to finance qualified conservation purposes.

The term “qualified conservation purpose” means:

1. Capital expenditures incurred for purposes of: (a) reducing energy consumption in publicly owned buildings by at least 20 percent; (b) implementing green community programs; (c) rural development involving the production of electricity from renewable energy resources; or (d) any facility eligible for the production tax credit under section 45 (other than Indian coal and refined coal production facilities);

2. Expenditures with respect to facilities or grants that support research in: (a) development of cellulosic ethanol or other nonfossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; (c) increasing the efficiency of existing technologies for producing nonfossil fuels; (d) automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (e) technologies to reduce energy use in buildings;

3. Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;

4. Demonstration projects designed to promote the commercialization of: (a) green building technology; (b) conversion of agricultural waste for use in the production of fuel or otherwise; (c) advanced battery manufacturing technologies; (d) technologies to reduce peak-use of electricity; and (e) technologies for the capture and
sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and

5. Public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).

There was originally a national limitation on qualified energy conservation bonds of $800 million. The national limitation was then increased by an additional $2.4 billion in 2009. As with other qualified tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.

(4) Qualified zone academy bonds

Qualified zone academy bonds (“QZABs”) are defined as any bond issued by a State or local government, provided that (1) at least 95 percent of the proceeds are used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy,” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A total of $400 million of QZABs has been authorized to be issued annually in calendar years 1998 through 2008. The authorization was increased to $1.4 billion for calendar year 2009, and also for calendar year 2010. For each of the calendar years 2011 through 2016, the authorization was set at $400 million.

(5) Qualified school construction bonds

Qualified school construction bonds must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bonds are issued by a State or local government within which such school is located; and (3) the issuer designates such bonds as a qualified school construction bond.

There is a national limitation on qualified school construction bonds of $11 billion for calendar years 2009 and 2010, and zero after 2010. If an amount allocated is unused for a calendar year, it may be carried forward to the following and subsequent calendar years. Under a separate special rule, the Secretary of the Interior may allocate $200 million of school construction bond authority for Indian schools.

c) Direct-pay bonds and expired tax-credit bond provisions

The Code provides that an issuer may elect to issue certain tax credit bonds as “direct-pay bonds.” Instead of a credit to the holder, with a “direct-pay bond” the Federal government
pays the issuer a percentage of the interest on the bonds. The following tax credit bonds may be issued as direct-pay bonds: new clean renewable energy bonds, qualified energy conservation bonds, and qualified school construction bonds. Qualified zone academy bonds may not be issued as direct-pay using any national zone academy bond allocation for calendar years after 2011 or any carryforward of such allocations. The ability to issue Build America Bonds and Recovery Zone bonds, which have direct-pay features, has expired.

\[ d) \quad \text{Description of Change} \]

The provision prospectively repeals authority to issue tax-credit bonds and direct-pay bonds.

Effective date.—The provision applies to bonds issued after December 31, 2017.

2. \textbf{Present State Law}

State law generally does not conform to federal provisions regarding issuance of tax-exempt bonds under section 235-2.3(b)(1), HRS. This is because state law provides its own provisions regarding bond issues, with tax provisions generally included within the bond statutes. See, for example, section 39-11, HRS, providing a state tax exemption for interest paid on general obligation bonds.

3. \textbf{Proposal in SB 2821, SD-1}

The bill proposes no change in state treatment of the bonds. Federal changes will not be operative for State income tax purposes.

4. \textbf{Comments of the Tax Foundation of Hawaii}

Traditionally, state law provides its own set of bond provisions so there is no need to conform with federal bond provisions.

\textbf{XIII. INSURANCE}

\textbf{A. Net operating losses of life insurance companies (sec. 810 of the Code)}

1. \textbf{Description of Federal Change – Omitted}

2. \textbf{Present State Law}

State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

3. \textbf{Proposal in SB 2821, SD-1}

The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.
4. Comments of the Tax Foundation of Hawaii

Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

B. Repeal of small life insurance company deduction (sec. 806 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

   State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

   4. Comments of the Tax Foundation of Hawaii

   Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

C. Adjustment for change in computing reserves (sec. 807 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

   State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

   4. Comments of the Tax Foundation of Hawaii

   Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

D. Repeal of special rule for distributions to shareholders from pre-1984 policyholders surplus account (sec. 815 of the Code)
   1. Description of Federal Change – Omitted
2. Present State Law

State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

E. Modification of proration rules for property and casualty insurance companies (sec. 832 of the Code)
1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

F. Modification of discounting rules for property and casualty insurance companies (sec. 832 of the Code)
1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

3. Proposal in SB 2821, SD-1
The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

G. **Repeal of special estimated tax payments (sec. 847 of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

H. **Computation of life insurance tax reserves (sec. 807 of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.
I. Modification of rules for life insurance proration for purposes of determining the dividends received deduction (sec. 812 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

J. Capitalization of certain policy acquisition expenses (sec. 848 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

State income tax law does not apply to insurance companies, which are subject to premium tax under the Insurance Code. See section 235-2.3(b)(28), HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state taxation of insurance companies. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Insurance companies are subject to premium tax, not income tax, so there is no need to conform with federal provisions relating to insurance companies.

K. Tax reporting for life settlement transactions, clarification of tax basis of life insurance contracts, and exception to transfer for valuable consideration rules (secs. 101, 1016, and 6050X of the Code)
   1. Description of Federal Change
      a) Present Law

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.
Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited. Under the limitation, the excludable amount may not exceed the sum of (1) the actual value of the consideration, and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includable in the buyer’s income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if (1) the transferee’s basis in the contract is determined in whole or in part by reference to the transferor’s basis in the contract, or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.

IRS guidance sets forth more details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts. The guidance relates to the character of taxable amounts (ordinary or capital) and to the taxpayer’s basis in the life insurance contract.

In Revenue Ruling 2009-13, the IRS ruled that income recognized under section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of sale of a cash value life insurance contract, the IRS ruled that the insured’s (seller’s) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the “inside buildup”), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling.

In Revenue Ruling 2009-14, the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (e.g., premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

b) Description of change

(1) In general

The TCJA imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits. The provision sets forth rules for determining the basis of a life insurance or annuity contract. Lastly, the provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.
(2) Reporting requirements for acquisitions of life insurance contracts

(a) Reporting upon acquisition of life insurance contract

The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer’s interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer’s name, address, and taxpayer identification number (“TIN”), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

(b) Reporting of seller's basis in the life insurance contract

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)), and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

(c) Reporting with respect to reportable death benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment (5) the payor’s estimate of the buyer’s basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale.
(3) Determination of basis

The provision provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as “cost of insurance”). This reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured’s (seller’s) basis is reduced by the cost of insurance.

(4) Scope of transfer for value rules

The provision provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

Effective date. – Under the provision, the reporting requirement is effective for reportable policy sales occurring after December 31, 2017, and reportable death benefits paid after December 31, 2017. The clarification of the basis rules for life insurance and annuity contracts is effective for transactions entered into after August 25, 2009. The modification of exception to the transfer for value rules is effective for transfers occurring after December 31, 2017.

2. Present State Law

State income tax law generally conforms to sections 101 and 1016, IRC. State law does not impose reporting requirements similar to section 6050X, IRC.

3. Proposal in SB 2821, SD-1

The bill proposes no change in sections 101 and 1016, IRC, and does not propose to adopt new reporting requirements. Federal changes to the transfer for value rules, including basis, will be operative for State income tax purposes but the federal reporting requirements will not.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to sections 101 and 1016, IRC.

XIV. Compensation

A. Modification of limitation on excessive employee remuneration (sec. 162(m) of the Code)

1. Description of Change
   a) Present Law: In general

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. Section 162(m) provides an explicit limitation on the deductibility of compensation expenses in the case of publicly traded corporate employers. The
otherwise allowable deduction for compensation with respect to a covered employee of a
publicly held corporation is limited to no more than $1 million per year. The deduction
limitation applies when the deduction attributable to the compensation would otherwise be
taken.

\textit{b) Covered employees}

Section 162(m) defines a covered employee as (1) the chief executive officer of the
corporation (or an individual acting in such capacity) as of the close of the taxable year and
(2) any employee whose total compensation is required to be reported to shareholders
under the Securities Exchange Act of 1934 (“Exchange Act”) by reason of being among the
corporation’s four most highly compensated officers for the taxable year (other than the chief
executive officer).\footnote{1008} Treasury regulations under section 162(m) provide that whether an
employee is the chief executive officer or among the four most highly compensated officers
should be determined pursuant to the executive compensation disclosure rules promulgated
under the Exchange Act.

In 2006, the Securities and Exchange Commission amended certain rules relating to
executive compensation, including which officers’ compensation must be disclosed under the
Exchange Act. Under the new rules, such officers are (1) the principal executive officer (or an
individual acting in such capacity), (2) the principal financial officer (or an individual acting in
such capacity), and (3) the three most highly compensated officers, other than the principal
executive officer or principal financial officer.

In response to the Securities and Exchange Commission’s new disclosure rules, the
Internal Revenue Service issued updated guidance on identifying which employees are covered
by section 162(m). The new guidance provides that “covered employee” means any employee
who is (1) as of the close of the taxable year, the principal executive officer (or an
individual acting in such capacity) defined in reference to the Exchange Act, or (2) among the three most
highly compensated for the taxable year (other than the principal executive officer or principal
financial officer), again defined by reference to the Exchange Act. Thus, under current
guidance, only four employees are covered under section 162(m) for any taxable year. Under
Treasury regulations, the requirement that the individual meet the criteria as of the last day of
the taxable year applies to both the principal executive officer and the three highest
compensated officers.

\textit{c) Definition of publicly held corporation}

For purposes of the deduction disallowance of section 162(m), a publicly held
corporation means any corporation issuing any class of common equity securities required to be
registered under section 12 of the Securities Exchange Act of 1934. All U.S. publicly traded
companies are subject to this registration requirement, including their foreign affiliates. A
foreign company publicly traded through American depository receipts (“ADRs”) is also
subject to this registration requirement if more than 50 percent of the issuer’s outstanding
voting securities are held, directly or indirectly, by residents of United States and either (i) the
majority of the executive officers or directors are United States citizens or residents, (ii) more
than 50 percent of the assets of the issuer are located in the United States, or (iii) the business of
the issuer is administered principally in the United States. Other foreign companies are not subject to the registration requirement.

d) Remuneration subject to the deduction limitation

(1) In general

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in section 280G) that are not deductible by the corporation.

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis; (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met (“performance-based compensation”); (3) payments to a tax-favored retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive’s gross income (such as employer-provided health benefits and miscellaneous fringe benefits); and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993. In addition, remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (e.g., is not performance-based compensation) because the payment of compensation is deferred until after termination of employment.

(2) Performance-based compensation

Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors,1017 (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate majority-approved vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

Compensation (other than stock options or other stock appreciation rights (“SARs”)) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. A stock option or SAR with an exercise price not less than the fair market value, on the date the option or SAR is granted, of the stock subject to the option or SAR, generally is treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards
have been met). This is the case because the amount of compensation attributable to the options or SARs received by the executive is based solely on an increase in the corporation’s stock price.

Stock-based compensation is not treated as performance-based if it depends on factors other than corporate performance.

e) Description of change

(1) Definition of covered employee

The provision revises the definition of covered employee to include both the principal executive officer and the principal financial officer. Further, an individual is a covered employee if the individual holds one of these positions at any time during the taxable year. The provision also defines as a covered employee the three (rather than four) most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer) who are required to be reported on the company’s proxy statement (i.e., the statement required pursuant to executive compensation disclosure rules promulgated under the Exchange Act) for the taxable year (or who would be required to be reported on such a statement for a company not required to make such a report to shareholders). This includes such officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a publicly held corporation, as well as such officers of a publicly traded corporation that would otherwise have been required to file a proxy statement for the year (for example, but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the nonapplication of the proxy statement requirement).

In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died. Compensation does not fail to be compensation with respect to a covered employee and thus subject to the deduction limit for a taxable year merely because the compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the employee’s death, or to a former spouse pursuant to a domestic relations order.

(2) Definition of publicly held corporation

The provision extends the applicability of section 162(m) to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. The proposed definition may include certain additional corporations that are not publicly traded, such as large private C or S corporations.

(3) Performance-based compensation and commissions exceptions

The provision eliminates the exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit. Thus, such compensation is taken into account in determining the amount of compensation with respect to
a covered employee for a taxable year that exceeds $1 million and is thus not deductible under section 162.

Effective date.—The provision applies to taxable years beginning after December 31, 2017. A transition rule applies to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017 and which was not modified in any material respect on or after such date. For purposes of the transition rule, compensation paid pursuant to a plan qualifies for this exception provided that the right to participate in the plan is part of a written binding contract with the covered employee in effect on November 2, 2017. For example, suppose a covered employee was hired by XYZ Corporation on October 2, 2017 and one of the terms of the written employment contract is that the executive is eligible to participate in the ‘XYZ Corporation Executive Deferred Compensation Plan’ in accordance with the terms of the plan. Assume further that the terms of the plan provide for participation after 6 months of employment, amounts payable under the plan are not subject to discretion, and the corporation does not have the right to amend materially the plan or terminate the plan (except on a prospective basis before any services are performed with respect to the applicable period for which such compensation is to be paid). Provided that the other conditions of the binding contract exception are met (e.g., the plan itself is in writing), payments under the plan are grandfathered, even though the employee was not actually a participant in the plan on November 2, 2017.

The fact that a plan was in existence on November 2, 2017 is not by itself sufficient to qualify the plan for the exception for binding written contracts.

The exception for remuneration paid pursuant to a binding written contract ceases to apply to amounts paid after there has been a material modification to the terms of the contract. The exception does not apply to new contracts entered into or renewed after November 2, 2017. For purposes of this rule, any contract that is entered into on or before November 2, 2017 and that is renewed after such date is treated as a new contract entered into on the day the renewal takes effect. A contract that is terminable or cancelable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancelable if it can be terminated or cancelled only by terminating the employment relationship of the covered employee.

2. **Present State Law**

State income tax law generally conforms to section 162, IRC.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in sections 162, IRC, meaning that federal changes will be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

We recommend continued conformity to sections 162, IRC.
B. Excise tax on excess tax-exempt organization executive compensation (sec. 4960 of the Code)
   1. Description of Federal Change – Omitted

   2. Present State Law

   State income tax law does not impose excise taxes on exempt organizations.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

   4. Comments of the Tax Foundation of Hawaii

   Traditionally, state law has not imposed “intermediate sanctions” or similar excise taxes on exempt organizations so there is no need to conform with federal credit provisions.

C. Treatment of qualified equity grants (secs. 83, 3401, and 6051 of the Code)

   1. Description of Change
      a) Present Law
         (1) Income tax treatment of employer stock transferred to an employee

   Specific rules apply to property, including employer stock, transferred to an employee in connection with the performance of services. These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer’s compensation deduction.

   Under these rules, an employee generally must recognize income in the taxable year in which the employee’s right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as “substantially vested”). Thus, if the employee’s right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee’s right to the stock is not substantially vested (referred to herein as “nonvested”), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee’s right becomes substantially vested. In this case, the amount includible in the employee’s income is the fair market value of the stock as of the date that the employee’s right to the stock is substantially vested (less any amount paid for the stock). However, if the employee’s right to the stock is nonvested at the time the stock is transferred to employee, under section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a “section 83(b)” election. If a proper and timely election under section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair
market value of the stock as of the date of transfer (less any amount paid for the stock). A section 83(b) election is available with respect to grants of “restricted stock” (nonvested stock), and does not generally apply to the grant of options.

In general, an employee’s right to stock or other property is subject to a substantial risk of forfeiture if the employee’s right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services. An employee’s right to stock or other property is transferable if the employee can transfer an interest in the property to any person other than the transferor of the property. Thus, generally, employer stock transferred to an employee by an employer is not transferable merely because the employee can sell it back to the employer.

In the case of stock transferred to an employee, the employer is allowed a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount included in the employee’s income as a result of transfer of the stock. The employer deduction generally is permitted in the employer’s taxable year in which or with which ends the employee’s taxable year when the amount is included and properly reported in the employee’s income.

These rules do not apply to the grant of a nonqualified option on employer stock unless the option has a readily ascertainable fair market value. Instead, these rules apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee. A section 83(b) election generally does not apply to the grant of options. If upon the exercise of an option, nonvested stock is transferred to the employee, a section 83(b) election may apply. The employer’s deduction is generally determined under the rules that apply to transfers of restricted stock, but a special accrual rule may apply under Treasury regulations when the transferred stock is substantially vested.

(2) Employment taxes and reporting

Employment taxes generally consist of taxes under the Federal Insurance Contributions Act (“FICA”), tax under the Federal Unemployment Tax Act (“FUTA”), and income taxes required to be withheld by employers from wages paid to employees (“income tax withholding”). Unless an exception applies under the applicable rules, compensation provided to an employee constitutes wages subject to these taxes.

FICA imposes tax on employers and employees, generally based on the amount of wages paid to an employee during the year. Special rules as to the timing and amount of FICA taxes apply in the case of nonqualified deferred compensation, as defined for FICA purposes.

The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance (“OASDI”) tax equal to 6.2 percent of covered wages up to the OASDI wage base ($127,200 for 2017); and (2) the
Medicare or hospital insurance ("HI") tax equal to 1.45 percent of all covered wages. The employee portion of FICA tax generally must be withheld and, along with the employer portion, remitted to the Federal government by the employer. FICA tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.

FUTA imposes a tax on employers of six percent of wages up to the FUTA wage base of $7,000.

Income tax withholding generally applies when wages are paid by an employer to an employee, based on graduated withholding rates set out in tables published by the Internal Revenue Service ("IRS"). Like FICA tax withholding, income tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.

An employer is required to furnish each employee with a statement of compensation information for a calendar year, including taxable compensation, FICA wages, and withheld income and FICA taxes. In addition, information relating to certain nontaxable items must be reported, such as certain retirement and health plan contributions. The statement, made on Form W-2, Wage and Tax Statement, must be provided to each employee by January 31 of the succeeding year.

(3) Statutory options

Two types of statutory options apply with respect to employer stock: incentive stock options ("ISOs") and options provided under an employee stock purchase plan ("ESPP"). Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. No amount is includible in an employee’s income on the grant, vesting, or exercise of a statutory option. In addition, generally no deduction is allowed to the employer with respect to the option or the stock transferred to an employee.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee’s gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a “disqualifying disposition”), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs and the employer may be allowed a corresponding deduction in the taxable year in which such disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Employment taxes do not apply with respect to the grant or vesting of a statutory option, transfer of stock pursuant to the option, or a disposition (including a disqualifying disposition) of the stock. However, certain special reporting requirements apply.
(4) Nonqualified deferred compensation

Compensation is generally includible in an employee’s income when paid to the employee. However, in the case of a nonqualified deferred compensation plan, unless the arrangement either is exempt from or meets the requirements of section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined), even if payment will not occur until a later year. In general, to meet the requirements of section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events.

Various exemptions from section 409A apply, including transfers of property subject to section 83. Nonqualified options are not automatically exempt from section 409A, but may be structured so as not to be considered nonqualified deferred compensation. A restricted stock unit ("RSU") is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee’s right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock (or either). An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of section 409A. The employer deduction generally is permitted in the employer’s taxable year in which or with which ends the employee’s taxable year when the amount is included and properly reported in the employee’s income.

b) Description of Change

(1) In general

The TCJA allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion ("inclusion deferral election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

If an employee elects to defer income inclusion under the provision, the income must be included in the employee’s income for the taxable year that includes the earliest of (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer; (2) the date the employee first becomes an excluded employee (as described below); (3) the first date on which any stock of the employer becomes readily tradable on an established securities market; (4) the date five years after the first date the employee’s right to the stock becomes substantially vested; or (5) the date on which the employee revokes her inclusion deferral election. It is intended that the limited circumstances outlined in section 83(c)(3) and applicable regulations apply with respect to the determination of when stock first becomes transferable or is no longer subject to a substantial risk of forfeiture. For example,
income inclusion cannot be delayed due to a lock-up period as a result of an initial public offering.

An inclusion deferral election is made in a manner similar to the manner in which a section 83(b) election is made. The provision does not apply to income with respect to nonvested stock that is includible as a result of a section 83(b) election. The provision clarifies that Section 83 (other than the provision), including subsection (b), shall not apply to RSUs. Therefore, RSUs are not eligible for a section 83(b) election. This is the case because, absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

An employee may not make an inclusion deferral election for a year with respect to qualified stock if, in the preceding calendar year, the corporation purchased any of its outstanding stock unless at least 25 percent of the total dollar amount of the stock so purchased is stock with respect to which an inclusion deferral election is in effect ("deferral stock") and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis. For purposes of this requirement, stock purchased from an individual is not treated as deferral stock (and the purchase is not treated as a purchase of deferral stock) if, immediately after the purchase, the individual holds any deferral stock with respect to which an inclusion deferral election has been in effect for a longer period than the election with respect to the purchased stock. Thus, in general, in applying the purchase requirement, an individual’s deferral stock with respect to which an inclusion deferral election has been in effect for the longest periods must be purchased first. A corporation that has deferral stock outstanding as of the beginning of any calendar year and that purchases any of its outstanding stock during the calendar year must report on its income tax return for the taxable year in which, or with which, the calendar year ends the total dollar amount of the outstanding stock purchased during the calendar year and such other information as the Secretary may require for purposes of administering this requirement.

A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option. In that case, the option is not treated as a statutory option and the rules relating to statutory options and related stock do not apply. In addition, an arrangement under which an employee may receive qualified stock is not treated as a nonqualified deferred compensation plan solely because of an employee’s inclusion deferral election or ability to make an election. Note that the exception from treatment as a nonqualified deferred compensation plan for purposes of section 409A applies solely with respect to an employee who may receive qualified stock.

Deferred income inclusion applies also for purposes of the employer’s deduction of the amount of income attributable to the qualified stock. That is, if an employee makes an inclusion deferral election, the employer’s deduction is deferred until the employer’s taxable year in which or with which ends the taxable year of the employee for which the amount is included in the employee’s income as described in (1)-(5) above.

When an inclusion deferral election is made with respect to stock transferred under an ESPP, the option is not considered an ESPP, such that when an inclusion deferral election is made in connection with the exercise of both ESPPs and ISOs, the options are not treated as
statutory options but rather as nonqualified stock options for FICA purposes (in addition to being subject to section 83(i) for income tax purposes).

(2) Qualified employee and qualified stock

Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary (as determined by the Secretary) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual (1) who was a one-percent owner of the corporation at any time during the 10 preceding calendar years, (2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity, (3) who is a family member of an individual described in (1) or (2), or (4) who has been one of the four highest compensated officers of the corporation for any of the 10 preceding taxable years. Note that an excluded employee includes an individual who first becomes a 1 percent owner or one of the 4 highest compensated officers in a taxable year, notwithstanding that such individual may not have been among such categories for the 10 preceding taxable years.

Qualified stock is any stock of a corporation if--

- an employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and
- the option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation (as described below).

However, qualified stock does not include any stock if, at the time the employee’s right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Qualified stock can only be such if it relates to stock received in connection with options or RSUs, and does not include stock received in connection with other forms of equity compensation, including stock appreciation rights or restricted stock.

A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year, and (2) the corporation has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted stock options, or restricted stock units (“RSUs”), with the same rights and privileges to receive qualified stock (“80-percent requirement”). For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present-law ESPP rules. However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a de minimis amount. In addition, rights and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU. Note that the requirement that 80 percent of
all applicable employees be granted stock options or restricted stock units with the same rights and privileges cannot be satisfied in a taxable year by granting a combination of stock options and RSUs, and instead all such employees must either be granted stock options or be granted restricted stock units for that year. It is intended that the requirement that 80 percent of all applicable employees be granted stock options or be granted restricted stock units apply consistently to eligible employees, whether they are new hires or existing employees.

For purposes of the provision, corporations that are members of the same controlled group under section 414(b) are treated as one corporation.

(3) Notice, withholding and reporting requirements

Under the provision, a corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee’s right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election). The notice must (1) certify to the employee that the stock is qualified stock, and (2) notify the employee (a) that the employee may (if eligible) elect to defer income inclusion with respect to the stock and (b) that, if the employee makes an inclusion deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee’s right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee’s tax liability with respect to such stock), and the amount of income to be included at the end of the deferral period will be subject to withholding as provided under the provision, as well as of the employee’s responsibilities with respect to required withholding. Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

An inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA are not affected. The provision includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election.

For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers. The employer must report on Form W-2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee. In addition, for any calendar year, the employer must report on Form W-2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year.

Effective date.—The provision generally applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017. Under a transition rule, until the Secretary (or the Secretary’s delegate) issues regulations or other guidance implementing the 80-percent and employer notice requirements under the provision, a corporation will be treated as complying with those requirements (respectively) if it complies with a reasonable good faith
interpretation of the requirements. The penalty for a failure to provide the notice required under the provision applies to failures after December 31, 2017. It is intended that the transition rule provided with respect to compliance with the 80-percent and employer notice requirements not be expanded beyond these specific items.

2. Present State Law

State income tax law generally conforms to section 83, IRC. State income tax law does not conform to the withholding provisions of the Code because Hawaii has its own withholding provisions in section 235-61 to 235-67 and 235-69, HRS, that depend on taxability under the Hawaii income tax law. State income tax law does not conform to the reporting provisions of the Code because Hawaii has its own requirement of reporting withheld taxes to employees in section 235-63, HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in sections 83, IRC, meaning that federal changes will be operative for State income tax purposes. Changes proposed to the withholding and reporting requirements will not be automatically operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to section 83, IRC, to facilitate compliance and decrease complexity.

D. Increase in excise tax rate for stock compensation of insiders in expatriated corporations (sec. 4985 of the Code)
   1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not impose excise taxes on expatriated corporations.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Traditionally, state law has not imposed excise taxes on expatriated corporations so there is no need to conform with federal credit provisions.
A. Treatment of gain or loss of foreign persons from sale or exchange of interests in partnerships engaged in trade or business within the United States (secs. 864(c) and 1446 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

B. Modification of the definition of substantial built-in loss in the case of transfer of partnership interest (sec. 743 of the Code)

1. Description of Federal Change

   a) Present Law

In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election under section 754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer.

If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments are to account for the difference between the transferee partner’s proportionate share of the adjusted basis of the partnership property and the transferee’s basis in its partnership interest. The adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.

Under the provision, a substantial built-in loss exists if the partnership’s adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.

Certain securitization partnerships and electing investment partnerships are not treated as having a substantial built-in loss in certain instances, and thus are not required to make basis adjustments to partnership property. For electing investment partnerships, in lieu of the partnership basis adjustments, a partner-level loss limitation rule applies.
b) Description of Change

The provision modifies the definition of a substantial built-in loss for purposes of section 743(d), affecting transfers of partnership interests. Under the provision, in addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all partnership’s assets in a fully taxable transaction for cash equal to the assets’ fair market value, immediately after the transfer of the partnership interest.

For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to section 754. The partnership has two assets, one of which, Asset X, has a built-in gain of $1 million, while the other asset, Asset Y, has a built-in loss of $900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of $300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells his partnership interest to another person, D, for $33,333. Under the provision, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). A substantial built-in loss exists under the partner-level test added by the provision, and the partnership adjusts the basis of its assets accordingly with respect to D.

2. Present State Law

State income tax law generally conforms to section 743, IRC.

3. Proposal in SB 2821, SD-1

The bill proposes no change in section 743, IRC, meaning that federal changes will be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to section 743, IRC, to facilitate compliance and decrease complexity.

C. Charitable contributions and foreign taxes taken into account in determining limitation on allowance of partner's share of loss (sec. 704 of the Code)

1. Description of Federal Change

   a) Present Law

A partner’s distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis (before reduction by current year’s losses) of the partner’s
interest in the partnership at the end of the partnership taxable year in which the loss occurred. Any disallowed loss is allowable as a deduction at the end of the first succeeding partnership taxable year, and subsequent taxable years, to the extent that the partner’s adjusted basis for its partnership interest at the end of any such year exceeds zero (before reduction by the loss for the year).

A partner’s basis in its partnership interest is increased by its distributive share of income (including tax exempt income). A partner’s basis in its partnership interest is decreased (but not below zero) by distributions by the partnership and its distributive share of partnership losses and expenditures of the partnership not deductible in computing partnership taxable income and not properly chargeable to capital account. In the case of a charitable contribution, a partner’s basis is reduced by the partner’s distributive share of the adjusted basis of the contributed property.

A partnership computes its taxable income in the same manner as an individual with certain exceptions. The exceptions provide, in part, that the deductions for foreign taxes and charitable contributions are not allowed to the partnership. Instead, a partner takes into account its distributive share of the foreign taxes paid by the partnership and the charitable contributions made by the partnership for the taxable year.

However, in applying the basis limitation on partner losses, Treasury regulations do not take into account the partner’s share of partnership charitable contributions and foreign taxes paid or accrued. The IRS has taken the position in a private letter ruling that the basis limitation on partner losses does not apply to limit the partner’s deduction for its share of the partnership’s charitable contributions. While the regulations relating to the loss limitation do not mention the foreign tax credit, a taxpayer may choose the foreign tax credit in lieu of deducting foreign taxes.

By contrast, under S corporation rules limiting the losses and deductions which may be taken into account by a shareholder of an S corporation to the shareholder’s basis in stock and debt of the corporation, the shareholder’s pro rata share of charitable contributions and foreign taxes are taken into account. In the case of charitable contributions, a special rule is provided prorating the amount of appreciation not subject to the limitation in the case of charitable contributions of appreciated property by the S corporation.

b) Description of Change

The TCJA modifies the basis limitation on partner losses to provide that the limitation takes into account a partner’s distributive share of partnership charitable contributions (as defined in section 170(c)) and taxes (described in section 901) paid or accrued to foreign countries and to possessions of the United States. Thus, the amount of the basis limitation on partner losses is decreased to reflect these items. In the case of a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner’s distributive share of the adjusted basis of the contributed property. In the case of a charitable contribution by the partnership of property whose fair market value exceeds its adjusted basis, a special rule provides that the basis limitation on partner losses does not apply to the extent of the partner’s distributive share of the excess.
2. **Present State Law**

   State income tax law generally conforms to section 704, IRC, except that state law in section 235-2.45(d), HRS, makes several modifications to section 704(b)(2) as it is applied to certain credit and loss allocations.

3. **Proposal in SB 2821, SD-1**

   The bill proposes no change in section 704, IRC, meaning that federal changes will be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

   We recommend continued conformity to section 704, IRC, to facilitate compliance and decrease complexity.

D. **Expansion of qualifying beneficiaries of an electing small business trust (sec. 1361 of the Code)**

   1. **Description of Federal Change**

      a) **Present Law**

      An electing small business trust (“ESBT”) may be a shareholder of an S corporation. Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT.

      The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation’s income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

      b) **Description of Change**

      The TCJA allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

2. **Present State Law**

   State income tax law generally conforms to the S corporation provisions of the Code with some modifications stated in the Hawaii S Corporation Income Tax Act, HRS chapter 235, part VII. Tax Information Release 2001-1 explains that a federal ESBT election is recognized as a Hawaii ESBT election.

3. **Proposal in SB 2821, SD-1**
The bill proposes no change in section 1361, IRC, meaning that federal changes will be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to section 1361, IRC, to facilitate compliance and decrease complexity.

E. Charitable contribution deduction for electing small business trusts (sec. 642(c) of the Code)

1. Description of Federal Change
   a) Present Law

An electing small business trust ("ESBT") may be a shareholder of an S corporation. The portion of an ESBT that consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation’s income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT. In addition to nonseparately computed income or loss, an S corporation reports to its shareholders their pro rata share of certain separately stated items of income, loss, deduction, and credit. For this purpose, charitable contributions (as defined in section 170(c)) of an S corporation are separately stated and taken by the shareholder.

The treatment of a charitable contribution passed through by an S corporation depends on the shareholder. Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts, rather than the deduction applicable to individuals, applies to the trust. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of adjusted gross income generally with a five-year carryforward of amounts in excess of this limitation.

b) Description of Change

The TCJA provides that the charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

2. Present State Law

State income tax law generally conforms to section 642, IRC. ESBTs are recognized in Hawaii income tax law through conformity with the federal S corporation provisions. Tax Information Release 2001-1 explains that a federal ESBT election is recognized as a Hawaii ESBT election.
3. Proposal in SB 2821, SD-1

The bill proposes no change in section 642, IRC, meaning that federal changes will be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to section 642, IRC, to facilitate compliance and decrease complexity.

F. Production period for beer, wine, and distilled spirits (sec. 263A of the Code)

1. Description of Federal Change

   a) Present Law in General

   The uniform capitalization (“UNICAP”) rules, which were enacted as part of the Tax Reform Act of 1986, require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable. For real or personal property acquired by the taxpayer for resale, section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

   In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property’s production period and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding two years, or (3) has an estimated production period exceeding one year and a cost exceeding $1,000,000. The production period with respect to any property is the period beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or held for sale. In the case of property that is customarily aged (e.g., tobacco, wine, and whiskey) before it is sold, the production period includes the aging period.

   b) Exceptions from UNICAP

   Section 263A provides a number of exceptions to the general capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts for the preceding three-taxable year period; such taxpayers are not required to include additional section 263A costs in inventory.

   Another exception exists for taxpayers who raise, harvest, or grow trees. Under this exception, section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any animal or plant having a reproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under section 447 or 448(a)(3)).
Freelance authors, photographers, and artists also are exempt from section 263A for any qualified creative expenses. Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist. However, such term does not include any expense related to printing, photographic plates, motion picture files, video tapes, or similar items.

c) Description of Change

The TCJA excludes the aging periods for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Thus, under the provision, producers of beer, wine and distilled spirits are able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period.

The provision does not apply to interest costs paid or accrued after December 31, 2019.

Effective date. – The provision is effective for interest costs paid or accrued after December 31, 2017.

2. Present State Law

State income tax law generally conforms to section 263A, IRC.

3. Proposal in SB 2821, SD-1

The bill proposes no change in section 263A, IRC, meaning that federal changes will be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend continued conformity to section 263A, IRC, to facilitate compliance and decrease complexity. We understand that this is a temporary provision.

G. Reduced rate of excise tax on beer (sec. 5051 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not conform to federal excise taxes on alcoholic beverages. Instead, a gallonage tax is imposed on such beverages under chapter 244D, HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.
4. Comments of the Tax Foundation of Hawaii

Traditionally, state law has imposed its own tax on alcohol sales so there is no need to conform with federal excise tax provisions.

H. Transfer of beer between bonded facilities (sec. 5414 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

State income tax law does not conform to federal excise taxes on alcoholic beverages. Instead, a gallonage tax is imposed on such beverages under chapter 244D, HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Traditionally, state law has imposed its own provision on alcohol sales so there is no need to conform with federal excise tax provisions.

I. Reduced rate of excise tax on certain wine (sec. 5041 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

State income tax law does not conform to federal excise taxes on alcoholic beverages. Instead, a gallonage tax is imposed on such beverages under chapter 244D, HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

J. Adjustment of alcohol content level for application of excise tax rates (sec. 5041 of the Code)
   1. Description of Federal Change – Omitted
2. **Present State Law**

State income tax law does not conform to federal excise taxes on alcoholic beverages. Instead, a gallonage tax is imposed on such beverages under chapter 244D, HRS.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

Traditionally, state law has imposed its own provision on alcohol sales so there is no need to conform with federal excise tax provisions.

K. **Definition of mead and low alcohol by volume wine (sec. 5041 of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not conform to federal excise taxes on alcoholic beverages. Instead, a gallonage tax is imposed on such beverages under chapter 244D, HRS.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

Traditionally, state law has imposed its own provision on alcohol sales so there is no need to conform with federal excise tax provisions.

L. **Reduced rate of excise tax on certain distilled spirits (sec. 5001 of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not conform to federal excise taxes on alcoholic beverages. Instead, a gallonage tax is imposed on such beverages under chapter 244D, HRS.

3. **Proposal in SB 2821, SD-1**
The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

Traditionally, state law has imposed its own provision on alcohol sales so there is no need to conform with federal excise tax provisions.

M. **Bulk distilled spirits (sec. 5212 of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not conform to federal excise taxes on alcoholic beverages. Instead, a gallonage tax is imposed on such beverages under chapter 244D, HRS.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

Traditionally, state law has imposed its own provision on alcohol sales so there is no need to conform with federal excise tax provisions.

N. **Modification of tax treatment of Alaska Native Corporations and Settlement Trusts (sec. 6039H and new secs. 139G and 247 of the Code)**

1. **Description of Federal Change**

   a) **Present Law**

   The Alaska Native Claims Settlement Act (“ANCSA”) established Native Corporations to hold property for Alaska Natives. Alaska Natives are generally the only permitted common shareholders of those corporations under section 7(h) of ANCSA, unless a Native Corporation specifically allows other shareholders under specified procedures.

   ANCSA permits a Native Corporation to transfer money or other property to an Alaska Native Settlement Trust (“Settlement Trust”) for the benefit of beneficiaries who constitute all or a class of the shareholders of the Native Corporation, to promote the health, education and welfare of beneficiaries and to preserve the heritage and culture of Alaska Natives.

   Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.
Special tax rules enacted in 2001 allow an election to use a more favorable tax regime for transfers of property by a Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust. There is also simplified reporting to beneficiaries.

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals, (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax. As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election. Also, contributions from a Native Corporation to an electing Settlement Trust generally will not result in the recognition of gross income by beneficiaries on account of the contribution. An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from State and local bonds for the same period. Amounts distributed in excess of the amount excludable is taxed to the beneficiaries as if distributed by the sponsoring Native Corporation in the year of distribution by the Trust, which means that the beneficiaries must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Native Corporation. Amounts distributed in excess of the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Native Corporation by a proportion, determined on a per share basis, of all contributions to all electing Settlement Trusts by the sponsoring Native Corporation. This rule prevents a stockholder from being able to take advantage of a decrease in value of a Native Corporation that is caused by a transfer of assets from the Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under Section 6034A.

The election to pay tax at the lowest rate is not available in certain disqualifying cases where transfer restrictions have been modified to allow a transfer of either: (a) a beneficial interest that would not be permitted by section 7(h) of the Alaska Native Claims Settlement Act if the interest were Settlement common stock, or (b) any stock in an Alaska Native Corporation that would not be permitted by section 7(h) if it were Settlement common stock and the Native Corporation thereafter makes a transfer to the Trust. Where an election is already in effect at the time of such disqualifying transfers, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be
taxed on the amount of any distributions received consistent with the applicable tax rate bracket.

b) Description of Change

The provision comprises three separate but related sections. The first section allows a Native Corporation to assign certain payments described in ANCSA to a Settlement Trust without having to recognize gross income from those payments, provided the assignment is in writing and the Native Corporation has not received the payment prior to assignment. The Settlement Trust is required to include the assigned payment in gross income when received.

The second section allows a Native Corporation to elect annually to deduct contributions made to a Settlement Trust. If the contribution is in cash, the deduction is in the amount of cash contributed. If the contribution is property other than cash, the deduction is the amount of the Native Corporation’s basis in the contributed property (or the fair market value of such property, if less than the Native Corporation’s basis), and no gain or loss can be recognized on the contribution. The Native Corporation’s deduction is limited to the amount of its taxable income for that year, and any unused deduction may be carried forward 15 additional years. The Native Corporation’s earnings and profits for the taxable year are reduced by the amount of any deduction claimed for that year.

Generally, the Settlement Trust must include income equal to the deduction by the Native Corporation. For contributions of property other than cash, the Settlement Trust takes a basis in the property equal to its basis in the hands of the Native Corporation immediately before the contribution (or the fair market value of such property, if less than the Native Corporation’s basis), and may elect to defer recognition of income associated with such property until the Settlement Trust sells or disposes of the property. In that case, any income that is deferred (i.e., the amount of income that would have been included upon contribution absent the election to defer) is treated as ordinary income, while any gain in excess of the amount that is deferred takes the same character as if the election had not been made. If property subject to this election is disposed of within the first taxable year subsequent to the taxable year in which the property was contributed to the Settlement Trust, the election is voided with respect to the property, and the Settlement Trust is required to pay any tax applicable to the disposition of the property, including interest, as well as a penalty of 10 percent of the amount of the tax. The provision provides for a four year assessment period in which to assess the tax, interest, and penalty amounts. The provision permits the amendment of the terms of any Settlement Trust agreement to allow this election within one year of the enactment of the provision, with certain restrictions.

The third section of the provision requires any Native Corporation which has made an election to deduct contributions to a Settlement Trust as described above to furnish a statement to the Settlement Trust containing: (1) the total amount of contributions; (2) whether such contribution was in cash; (3) for non-cash contributions, the date that such property was acquired by the Native Corporation and the adjusted basis of such property on the contribution date; (4) the date on which each contribution was made to the Settlement Trust; and (5) such information as the Secretary determines is necessary for the accurate reporting of income relating to such contributions.
Effective date.—The provision relating to the exclusion for ANCSA payments assigned to Settlement Trusts is effective to taxable years beginning after December 31, 2016.

The provision relating to the deduction of contributions is effective for taxable years for which the Native Corporation’s refund statute of limitations period has not expired, and the provision provides a one-year waiver of the refund statute of limitations period in the event that the limitation period expires before the end of the one-year period beginning on the date of enactment.

The provision relating to the reporting requirement applies to taxable years beginning after December 31, 2016.

2. Present State Law

State income tax law would generally conform to new sections 139G and 247, IRC, because they are in chapter 1 of the Code. State income tax law generally does not conform to section 6039H, IRC, which is a reporting provision.

3. Proposal in SB 2821, SD-1

The bill proposes no change in section 139G or 247, IRC, meaning that the new federal sections will be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

We recommend conformity to new sections 139G and 247, IRC, to facilitate compliance and decrease complexity.

O. Amounts paid for aircraft management services (sec. 4261 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not conform to federal excise taxes on air transportation.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal air transportation excise tax provisions.
P. Opportunity zones (new secs. 1400Z-1 and 1400Z-2 of the Code)

1. Description of Federal Change

   a) Present Law

   The Code occasionally has provided several incentives aimed at encouraging economic growth and investment in distressed communities by providing Federal tax benefits to businesses located within designated boundaries.

   One of these incentives is a federal income tax credit that is allowed in the aggregate amount of 39 percent of a taxpayer investment in a qualified community development entity (CDE). In general, the credit is allowed to a taxpayer who makes a “qualified equity investment” in a CDE which further invests in a “qualified active low-income community business.” CDEs are required to make investments in low income communities (generally communities with 20 percent or greater poverty rate or median family income less than 80 percent of statewide median). The credit is allowed over seven years, five percent in each of the first three years and six percent in each of the next four years. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed. The Department of Treasury’s Community Development Financial Institutions Fund (“CDFI”) allocates the new markets tax credits.

   The maximum annual amount of qualified equity investments is $3.5 billion for calendar years 2010 through 2019. The new markets tax credit is set to expire on December 31, 2019. No amount of unused allocation limitation may be carried to any calendar year after 2024.

   b) Description of Change

   The TCJA provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment in the qualified opportunity fund.

   The provision allows for the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in Section 45D(e). The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

   Governors (including the chief executive of the District of Columbia) may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. If the number of low-income communities in a State is less than 100, the Governor may designate up to 25 tracts, otherwise the Governor may designate tracts not exceeding 25 percent of the number of low-income communities in the State. Governors are required to provide particular consideration to areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such
as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations.

In addition, each population census tract in each U.S. possession that is a low-income community is deemed certified and designated as a qualified opportunity zone effective on the date of enactment.

The provision provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property. The provision intends that the certification process for a qualified opportunity fund will be done in a manner similar to the process for allocating the new markets tax credit. The provision provides the Secretary authority to carry out the process.

If a qualified opportunity fund fails to meet the 90 percent requirement and unless the fund establishes reasonable cause, the fund is required to pay a monthly penalty of the excess of the amount equal to 90 percent of its aggregate assets, over the aggregate amount of qualified opportunity zone property held by the fund multiplied by the underpayment rate in the Code. If the fund is a partnership, the penalty is taken into account proportionately as part of each partner’s distributive share.

Qualified opportunity zone property includes: any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.

The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum deferral amount, the capital gains must be recognized and included in gross income as under present law.

If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or December 31, 2026. Only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the provision.

The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional five
percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain.

The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

The Secretary or the Secretary’s delegate is required to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment. The report is to include an assessment of investments held by the qualified opportunity fund nationally and at the State level. To the extent the information is available, the report is to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments. The report is also to include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.

Effective date.—The provision is effective on the date of enactment.

2. Present State Law

State income tax law would generally conform to new section 1400Z, IRC, because it is in chapter 1 of the Code. State income tax law generally does not conform to section 6039H, IRC, which is a reporting provision.

3. Proposal in SB 2821, SD-1

The bill proposes to decouple from this provision in proposed section 235-2.3(b)(51), HRS, meaning that the new federal section will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Traditionally, state income tax law has not conformed to federal incentive provisions such as empowerment zones and recovery zones. We recommend nonconformity to be consistent with this philosophy.

XVI. EXEMPT ORGANIZATIONS
A. Unrelated business taxable income separately computed for each trade or business activity (sec. 512(a) of the Code)

1. Description of Federal Change
   a) Present Law
      (1) Tax exemption for certain organizations

      Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

      (2) Unrelated business income tax, in general

      An exempt organization generally may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (e.g., program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization’s unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.

      The unrelated business income tax (“UBIT”) generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization’s tax-exempt functions. An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

      Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities. Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

      (3) Organizations subject to tax on unrelated business income

      Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts); (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a); and (3) certain State colleges and universities.

      (4) Exclusions from Unrelated Business Taxable Income
Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries. Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

(5) Specific deduction against unrelated business taxable income

In computing unrelated business taxable income, an exempt organization may take a specific deduction of $1,000. This specific deduction may not be used to create a net operating loss that will be carried back or forward to another year.

In the case of a diocese, province or religious order, or a convention or association of churches, a specific deduction is allowed with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.

(6) Operation of multiple unrelated trades or businesses

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business. Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions. As a result, an organization may use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

b) Description of change

For an organization with more than one unrelated trade or business, the TCJA requires that unrelated business taxable income first be computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under section 512(b)(12). The organization’s unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose.

The result of the provision is that a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year. The provision generally does not, however, prevent an organization from using a deduction from one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate.
Effective date.—The provision is effective for taxable years beginning after December 31, 2017. Under a special transition rule, net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date are not subject to the rule of the provision.

2. Present State Law

State law generally conforms to the provisions in IRC sections 512 to 514 regarding the determination of UBIT, except that state law, under HRS section 235-2.4(aa), provides for different methodology for determining what income is considered within the state and subject to state income tax, and it also provides that the UBIT tax rates are those generally provided for corporations and individuals.

3. Proposal in SB 2821, SD-1

The bill does not propose any changes relating to UBIT, meaning that the federal changes would be operative for Hawaii income tax purposes.

4. Comments of the Tax Foundation of Hawaii

Traditionally, state law has not imposed “intermediate sanctions” or similar excise taxes on exempt organizations so there is no need to conform with federal credit provisions.

We recommend continued conformity on this issue to avoid further complexity and unintended consequences.

B. Excise tax based on investment income of private colleges and universities (new sec. 4968 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not impose excise taxes on exempt organizations.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

We do not recommend conforming to this provision.

XVII. INTERNATIONAL TAX PROVISIONS
A. Deduction for foreign-source portion of dividends received by domestic corporations from specified 10-percent owned foreign corporations (new sec. 245A of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

The section added by this portion of the TCJA, section 245A, IRC, is excluded from state conformity by section 235-2.3(b)(17), HRS, which excludes sections 241 to 247, IRC.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

B. Special rules relating to sales or transfers involving specified 10-percent owned foreign corporations (secs. 367(a)(3)(C), 961, 1248 and new sec. 91 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

Section 367, IRC, is excluded from state conformity by section 235-2.3(b)(20), HRS.

State law normally would conform to section 91, IRC, because it is in chapter 1 of the Code.

3. Proposal in SB 2821, SD-1

The bill proposes to exclude section 91, IRC, by new section 235-2.3(b)(4), HRS.
4. **Comments of the Tax Foundation of Hawaii**

We recommend no change from the proposed bill relating to these provisions. There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

C. **Treatment of deferred foreign income upon transition to participation exemption system of taxation and deemed repatriation at two-tier rate (secs. 78, 904, 907 and 965 of the Code)**

1. **Brief Description of Federal Change**

The TCJA uses the mechanics under subpart F, IRC, to impose a one-time ‘toll tax’ on the undistributed, not previously taxed post-1986 foreign earnings and profits of certain U.S.-owned corporations as part of the transition to a territorial system. It amends section 965, IRC, to increase the subpart F income of a ‘specified foreign corporation’ for the last tax year of such corporation that begins before 2018 by the corporation’s accumulated deferred foreign income. The TCJA then requires U.S. shareholders of the specified foreign corporation to include in income its pro-rata share of the increased subpart F income.

The TCJA uses ‘measurement dates’ to determine the includible amount of deferred foreign income (i.e., the subpart F income of the specified corporation would be increased by no less than the corporation’s accumulated deferred foreign income determined as of certain measurement dates). The mandatory inclusion is the higher amount as determined on measurement dates November 2, 2017 and December 31, 2017. Accumulated deferred foreign income includes all post-1986 earnings and profits, not including previously taxed income or income that is effectively connected with the conduct of a trade or business in the United States. In addition, dividend distributions made by the specified foreign corporation during its last taxable year beginning before 2018 are disregarded. In addition, dividends paid to another specified foreign corporation are excepted from this ‘addback’ rule.

2. **Present State Law**

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

In particular, Subpart F is part of Subchapter N of the Code, all of which (other than foreign currency transaction rules) is excluded by section 235-2.3(b)(31), HRS.

Section 78, IRC, is excluded from state conformity by section 235-2.3(b)(2), HRS.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.
4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

For this item, we need to emphasize that the “deemed repatriation toll charge” in the TCJA is not a provision to which Hawaii normally conforms. Such amounts would be excluded from preapportionment income the same as normal Subpart F inclusions and section 78, IRC, gross-ups. Therefore, Hawaii lawmakers should not be expecting a revenue gain as a result of the deemed repatriation toll charge.

D. Election to increase percentage of domestic taxable income offset by overall domestic loss treated as foreign source (sec. 904(g) of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

E. Deduction for foreign-derived intangible income and global intangible low-taxed income (new sec. 250 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

State law normally would conform to section 250, IRC, because it is in chapter 1 of the Code.
3. **Proposal in SB 2821, SD-1**

The bill proposes to exclude section 250, IRC, by new section 235-2.3(b)(20), HRS.

4. **Comments of the Tax Foundation of Hawaii**

We recommend no change from the proposed bill relating to these provisions. There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

**F. Special rules for transfers of intangible property from controlled foreign corporations to United States shareholders (new sec. 966 of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

**G. Repeal of section 902 indirect foreign tax credits; determination of section 960 credit on current year basis (secs. 902 and 960 of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.
4. **Comments of the Tax Foundation of Hawaii**

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

**H. Source of income from sales of inventory determined solely on basis of production activities (sec. 863(b) of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

**I. Separate foreign tax credit limitation basket for foreign branch income (sec. 904 of the Code)**

1. **Description of Federal Change – Omitted**

2. **Present State Law**

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. **Proposal in SB 2821, SD-1**

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. **Comments of the Tax Foundation of Hawaii**

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.
J. Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment (sec. 955 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

   State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

   4. Comments of the Tax Foundation of Hawaii

   There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

K. Repeal of treatment of foreign base company oil related income as subpart F income (sec. 954(a) of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law

   State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

   4. Comments of the Tax Foundation of Hawaii

   There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

L. Modification of stock attribution rules for determining CFC status (secs. 318 and 958 of the Code)
   1. Description of Federal Change – Omitted
   2. Present State Law
State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

State law normally conforms to section 318, IRC, which provides rules for attribution of stock ownership for various purposes.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes, except for changes in section 318 which are expected to have no substantive effect on domestic tax provisions of the Code.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

M. Modification of definition of United States shareholder (sec. 951 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

N. Elimination of requirement that corporation must be controlled for 30 days before subpart F inclusions apply (sec. 951(a)(1) of the Code)

1. Description of Federal Change – Omitted

2. Present State Law
State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

O. Current year inclusion of foreign high return amounts or global intangible low-taxed income by United States shareholders (secs. 78 and 960 and new sec. 951A of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

Section 78, IRC, is excluded from state conformity by section 235-2.3(b)(2), HRS.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

P. Base erosion using deductible cross-border payments between affiliated companies (secs. 6038A and 6038C and new secs. 59A and 59B of the Code)

1. Description of Federal Change – Omitted

2. Present State Law
State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

State income tax law does not incorporate special reporting requirements in sections 6038A and 6038C, IRC.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

Q. Limitations on income shifting through intangible property transfers (secs. 367, 482, and 936 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

State income tax law excludes section 367, IRC, under section 235-2.3(b)(20), HRS.

State income tax law normally conforms to section 482, IRC, which provides that gross income, deductions, credits, or allowances may be allocated among commonly controlled businesses to prevent evasion of taxes or clearly to reflect income.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.
R. Certain related party amounts paid or accrued in hybrid transactions or with hybrid entities (sec. 267A of the Code)
   1. Description of Federal Change – Omitted

   2. Present State Law

   State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

   State law normally would conform to section 267A, IRC, because it is in chapter 1 of the Code.

   3. Proposal in SB 2821, SD-1

   The bill proposes to exclude section 267A, IRC, by new section 235-2.3(b)(21), HRS.

   4. Comments of the Tax Foundation of Hawaii

   We recommend no change from the proposed bill relating to these provisions. There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.

S. Restriction on insurance business exception to the passive foreign investment company rules (sec. 1297 of the Code)
   1. Description of Federal Change – Omitted

   2. Present State Law

   State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

   State income tax law excludes the passive foreign investment company provisions of the IRC under section 235-2.3(b)(35), HRS.

   3. Proposal in SB 2821, SD-1

   The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

   4. Comments of the Tax Foundation of Hawaii

   There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.
T. Repeal of fair market value of interest expense apportionment (sec. 864 of the Code)

1. Description of Federal Change – Omitted

2. Present State Law

State income tax law does not incorporate any of the international provisions of the Code because state law has its own system, called UDITPA (HRS chapter 235, part II) to apportion a taxpayer’s income among jurisdictions that may impose income tax.

3. Proposal in SB 2821, SD-1

The bill proposes no change in state treatment. Federal changes will not be operative for State income tax purposes.

4. Comments of the Tax Foundation of Hawaii

There is no need to conform with federal provisions relating to international taxation because most states, including Hawaii, have a very different system.
Honorable Chair Luke and committee members:

I am Kris Coffield, representing IMUAlliance, a nonpartisan political advocacy organization that currently boasts over 400 members. On behalf of our members, we offer this testimony in support of the intent of, with suggested amendments for Senate Bill 2821, SD 1, relating to conformity to the internal revenue code.

We support the overall revenue generation initiative undertaken by this bill, which would send an estimated $9.2 million flowing into our state’s coffers. Our state needs additional revenue to care for the homeless, build affordable housing, provide a quality education to all of our keiki, nurture and protect our natural resources, and more. Increasing revenue to meet these needs is imperative in any year, even more so at a time when the federal government is imposing a system of fiscal austerity upon the country that will push the financial responsibility for the provision of basic services even further upon states and municipalities.

That said, we urge you to strike Section 6 from this bill and prevent Hawai’i from needlessly conforming our estate tax code with federal law. December of 2017, the Republican controlled United States Congress passed the largest tax overhaul in a generation on strictly party-line votes. Situated amidst the $1.5 trillion tax cut is a particularly pernicious provision that’s emblematic of the constituency toward which the entire proposal is geared: a doubling of the amount of money that's automatically exempt from the federal estate tax to roughly $11 million for an unmarried individual or $22 million for a married household filing jointly.

Even if the old exemption levels had remained in place at $5.5 million per person ($11 million for a married couple), fewer than 11,500 estates would have had to file an estate tax return...
in 2018, according to estimates from the Tax Policy Center, of which only roughly 5,500 would have ended up owing any tax at all. Those numbers drop sharply under the new tax law. Less than 4,000 estates will have to file every year, with fewer than 1,800 paying taxes at the end of the day.

Moreover, as financial writer Jeanne Sahadi has argued, even if the estate tax rules actually do revert back to their pre-2018 levels in 2025, when they must be reauthorized by Congress, there's still good news for the heirs of the affluent: the increased exemption can be used for lifetime gifts. A wealthy person may give away money while alive, tax free, up to the amount of the estate tax exemption, with that same amount reducing the applicable tax exemption upon their death. Today's higher exemption levels will even retain their benefit if the estate tax exemption level falls in the future, under the GOP tax plan. So, if you’re a rich investor who lives for at least another eight years and gives your kids an $11 million gift in 2018 and the estate tax resets in 2025, much to your lifeless chagrin, you’re effectively giving your nestling bluebloods $5.5 million more, tax free, then if you had waited until your untimely passing to bequeath to them the same amount.

Hawai‘i has an obligation to rectify this giveaway to the rich—which ultimately results in greater governmental austerity—at the state level. Accordingly, rather than conform to the Tax Cuts and Jobs Act of 2017, per Section 6 of this bill, we should decouple our state’s tax exemption thresholds from federal law. Prior to passage of the TCJA, Hawai‘i (and Delaware) had the highest estate tax exemption thresholds in the nation (among states that have estate taxes) because of our reliance on federal conformity to set such thresholds. Similarly, as indicated above, wealthy island residents will reap the financial blessings of the TCJA regardless of whether or not we choose to conform, with the 18 to 40 percent federal estate tax now repealed on estate values between $5.5 million and $11 million for individuals and $11 million and $22 million for couples.

We must countervail the heartless fiscal policies of the Trump administration with a devotion to the common good. Mahalo for the opportunity to testify in support of the intent of this bill.

Sincerely,
Kris Coffield
Executive Director
IMUAlliance
Dear Chair Luke, Vice Chair Cullen, and members of the Committee:

Thank you for the opportunity to providing COMMENTS on SB 2821 SD1, which would conform Hawaii income and estate and generation-skipping transfer tax laws to the Internal Revenue Code of 1986, as amended as of December 31, 2017.

Even before the passage of the federal Tax Cuts and Jobs Act (TCJA), Delaware and Hawai‘i had the highest estate tax exemption thresholds among the states that have estate taxes, due to their and our conforming to the federal level. We should follow the example of the other states and decouple our estate tax exemption amounts from the federal law.

If we fail to decouple, the TCJA’s doubling of the already-high 2017 exemption amounts (see table on next page) will cause Hawai‘i to lose significant amounts of revenue. It would mean that the state would lose estate tax revenue on inheritance amounts between $5.5 and $11 million. Instead, Hawai‘i’s exemption levels could be kept where they were prior to the passage of the TCJA or decreased further to relatively recent prior levels.

With Hawai‘i – and especially this Committee – facing tremendous budget pressures, can we really afford to give up this revenue, due to a change in federal law that none of our elected Congressional representatives voted for?

Whether or not Hawai‘i continues to conform to the federal law, wealthy taxpayers will no longer be required to pay between 18 and 40 percent of their estate values between $5.5 and $11 million in federal tax. That is tremendous tax break for literally the richest among us. Do they need another from the state of Hawai‘i?

Since these heirs will be saving significantly at the federal level, they can easily afford to pay more at the state level. Currently Hawai‘i’s top estate tax rate is 15.7 percent. In comparison, in 2015 Washington had the highest maximum estate tax rate at 20 percent, and 11 states had a maximum rate of 16 percent. Hawai‘i could capture additional revenue by increasing our estate tax rates to within such a range.

We appreciate your consideration of this testimony.
The Hawai‘i Appleseed Center for Law and Economic Justice is committed to a more socially just Hawai‘i, where everyone has genuine opportunities to achieve economic security and fulfill their potential. We change systems that perpetuate inequality and injustice through policy development, advocacy, and coalition building.

Federal Estate Tax

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[1] [https://en.wikipedia.org/wiki/Estate_tax_in_the_United_States](https://en.wikipedia.org/wiki/Estate_tax_in_the_United_States)
March 13, 2018

TO: Honorable Chair Luke and Members of Finance Committee

RE: SB2821 SD1 Relating to Conformity to the Internal Revenue Code

Opposition for hearing on March 15

Americans for Democratic Action is an organization founded in the 1950s by leading supporters of the New Deal and led by Patsy Mink in the 1970s. We are devoted to the promotion of progressive public policies.

We oppose SB 2821 SD1 in its current form as we object to doubling the amount of inheritance exempt from the estate tax from an already high of 5.5 million dollars to 11 million dollars. Delaware and Hawaii have had the highest estate tax exemption already. Hawaii will lose significant tax revenue if we have this high a level of exemption. This is an exemption that benefits the wealthy not the working class.

Thank you for your consideration.

Sincerely,

John Bickel
President
CHAIR LUKE, VICE CHAIR CULLEN, AND MEMBERS OF THE COMMITTEE:
I OPPOSE SB2821 SD1 which would conform Hawaii’s Estate Tax to the IRS Code as revised in 2017, i.e. would double the dollar limit of exemption from Hawaii estate taxes.

The Estate Tax rightly aims to prevent the increasing concentration of wealth in a limited number of families, by taking part of an estate’s value and returning it to government where it will benefit the public. Estate taxes generally increase with the size of an estate as they do in Hawaii under current law.

The “Tax Cuts and Jobs” Act of December 2017 doubles the amount of wealth which is exempt from the federal Estate Tax from an already generous $5,490,000 to $11,200,000 for an individual and from $10,980 to $22,400,000 for a surviving spouse. Thus from this year on, those who inherit money from estates up to these very large amounts will no longer pay the federal estate tax.

Hawaii’s Estate Tax exemption value has been tied to the federal Estate Tax exemption value for years, which has resulted in more estates being untaxed, or taxed at a lower amount, than any other state except Delaware.

Why should Hawaii lose needed tax income from the estates of very, very wealthy people whose inheritors will receive a big windfall from the new federal tax law of 2017? As the Legislature struggles to fund all the worthwhile and even critical programs before it (homelessness, unfunded pension liabilities, education, the looming cost of addressing sea level rise, etc.), it seems highly irrational to pass SB2821 SD1.

It would make much more sense to decouple our estate tax limitations from the federal tax code of 2017. Other states already do so. The exemption limit could
be set at its already generous limit of $5,500,000 - or even drop the exemption limit further to correspond to its historical values over the past decade.

In fact, Hawaii could to its benefit increase our estate tax rates for large estates, since these inheritors will be saving 18% to 40% in federal taxes starting this year.

Please consider amending this bill to increase estate tax rates on large estates, and to decouple state from federal estate tax exclusion limitations. At the least, please do not pass SB2821 SD1 in its current form.

Thank you for the opportunity to provide testimony.
To: The Honorable Sylvia Luke, Chair
    and Members of the House Committee on Finance

Date: Thursday, March 15, 2018
Time: 2:30 P.M.
Place: Conference Room 308, State Capitol

From: Linda Chu Takayama, Director
    Department of Taxation

Re: S.B. 2821, S.D. 1, Relating to the Conformity to the Internal Revenue Code

The Department of Taxation (Department) strongly supports S.B. 2821, S.D. 1, an Administration measure, and offers the following comments for the Committee's consideration.

S.B. 2821, S.D. 1, conforms Hawaii’s income and estate and generation-skipping transfer taxes to the Internal Revenue Code (IRC) as of December 31, 2017. Hawaii Revised Statutes (HRS) sections 235-2.5(c) and 236E-4, require the Department to submit legislation to each regular session of the legislature to adopt the Code as it exists on the December 31 preceding the regular session.

S.B. 2821, S.D. 1, amends HRS section 235-2.3(a), to conform the Hawaii income tax law to the operative IRC sections of subtitle A, chapter 1, as amended as of December 31, 2017. Generally, subtitle A, chapter 1, refers to IRC sections 1-1400Z-2. S.B. 2821, S.D. 1, also amends HRS section 236E-3, to conform the Hawaii estate and generation-skipping transfer tax law to the operative IRC sections of subtitle B, as amended as of December 31, 2017. Generally, subtitle B refers to IRC sections 2001 through 2801.

In addition, S.B. 2821, S.D. 1, amends Hawaii income tax law to account for two major changes in federal tax law, the new partnership audit rules and the Tax Cuts and Jobs Act, both discussed below.

**Tax Cuts and Jobs Act**

The Tax Cuts and Jobs Act, P.L. 115-97, enacted December 22, 2017 (the Act), made major changes to individual and corporate income taxes and to the estate tax. The Department has studied the Act extensively and has made comprehensive recommendations. The Department’s recommendations are reflected in S.B. 2821, S.D. 1.
In general, the Department recommends conforming closely to the IRC to ease the administration of the income tax and estate tax as much as possible. However, in this case, the Department is recommending non-conformity in several important areas.

First, the Department recommends maintaining the current allowance of individual itemized deductions, including the mortgage interest deduction and the state and local tax deduction. This will ensure that Hawaii individual taxpayers do not face a Hawaii income tax increase due to the operation of the federal changes. These provisions are addressed throughout Section 3 of the bill at HRS section 235-2.4.

Second, the Department recommends not conforming to the 20% deduction for income from pass-through entities under new IRC section 199A. This provision is a response to the cut in the federal corporate tax rate. The Department believes this deduction is inappropriate for Hawaii income tax purposes. Forbes\(^1\) reports the relative effective tax rates at the federal level before and after the Act.

<table>
<thead>
<tr>
<th></th>
<th>Before the Act</th>
<th>After the Act (without deduction)</th>
<th>After the Act (with deduction)</th>
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<tbody>
<tr>
<td>C corporations</td>
<td>50.47%</td>
<td>39.8%</td>
<td>39.8%</td>
</tr>
<tr>
<td>Passthroughs</td>
<td>40.8%</td>
<td>37%</td>
<td>29.6%</td>
</tr>
<tr>
<td>Differential</td>
<td>9.67</td>
<td>2.8</td>
<td>10.2</td>
</tr>
</tbody>
</table>

This shows that the cut in the federal corporate tax rate would have decreased the benefit of organizing as a pass-through from nearly 10 percentage points to less than 3 percentage points. Instead, given the pass-through deduction, the differential remains approximately 10 percentage points. The Department does not agree with this justification for the deduction, nonetheless, the maintenance of the relative effective tax rates is not a coincidence. This demonstrates part of the reason why the pass-through deduction was enacted and why it is the size that it is.

Hawaii has made no change to its corporate tax rates, so there is no change in the relative tax rates to address with such a deduction. This provision is addressed in S.B. 2821, S.D. 1, in Section 2 at HRS section 235-2.3(b)(17).

Third, the Department recommends not conforming to bonus depreciation under IRC section 168(k). Bonus depreciation was introduced in 2003, since then, Hawaii has not allowed bonus depreciation. Under prior law, federal bonus depreciation was equal to 50% of the cost of qualified property. Under the Act, federal bonus depreciation is expanded to 100% of the cost of qualified property. S.B. 2821, S.D. 1, addresses this provision. However, because Hawaii does not conform to IRC section 168(k) currently, no statutory change is necessary to continue to not conform.

Fourth, the Department recommends continuing conformity to the corporate tax

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provisions Hawaii currently conforms to. Two noteworthy provisions that were changed are the business interest deduction in IRC section 163(j) and the net operating loss (NOL) deduction in IRC section 172. The two provisions are discussed briefly below. S.B. 2821, S.D. 1 addresses these provisions. Hawaii currently conforms to these IRC sections, therefore, no statutory change is necessary to continue conforming.

The business interest deduction (IRC section 163(j)) is limited to the sum of the business’s interest income, 30% of its adjusted taxable income, and any floor financing interest of the business. Any disallowed interest deduction may be carried forward indefinitely. The interest deduction limitations do not apply to taxpayers whose average annual gross receipts for the prior three years do not exceed $25 million.

The Act limits NOL deductions to 80% of taxable income. The Act also disallows any carryback of NOLs, except for certain farms, and allows indefinite carryforward of NOLs. The NOL limits do not apply to property and casualty insurance companies.

Fifth, the Act increased the estate tax and generation-skipping transfer tax exemption amounts from $5,490,000 to $10,000,000. S.B. 2821, S.D. 1, maintains the current exclusion amounts of $5,490,000. The Department notes that extensive amendments to HRS chapter 236E are required in order to decouple from the estate tax exemption amount. As amended by S.B. 2821, S.D. 1, HRS chapter 236E does not contain an audit provision. Due to the close conformity with the federal estate and generation-skipping transfer taxes in the past, an independent audit provision in Hawaii law was not necessary. However, with the nonconformity to the federal exemption amounts, the Department recommends including an audit provision in HRS chapter 236E.

The Department recommends amending S.B. 2821, S.D. 1, to add a new Section 13 to the bill to read as follows:

“SECTION 13. Chapter 236E is amended by adding a new section 236E-__ to read as follows:

“236E-__ Audit of return; procedure upon failure to file return; additional taxes; limitation period. (a) Audit. The director of taxation, or the director’s designee, is authorized and empowered to examine all account books, bank books, bank statements, records, vouchers, copies of federal tax returns, and any and all other documents and evidences having any relevancy to the determination of any amount relevant to Hawaii transfer tax, as required to be returned under this chapter, and the director may employ the director’s powers under section 231-7 for such purposes.

(b) Additional taxes. If the department of taxation discovers from the examination of the return or otherwise that any amount has not been assessed or otherwise properly included in determining any amount relevant to Hawaii transfer tax, it may assess such amounts.

(c) Procedure upon failure to file a return. If the person
required to file the return required under this chapter fails to file the return or declines to authenticate a return, the department of taxation shall make a return for the person from the best information obtainable and shall levy and assess against the person the tax as shown on such return.

(d) For purposes of this section, the department of taxation shall give notice of the assessment to the person required to file the return required under this chapter. The person so put on notice shall have thirty days to confer with the department as to the proposed assessment. After the expiration of thirty days from such notification the department shall finalize the assessment and shall give notice to the person required to file the return required under this chapter of the tax and interest and penalties if any. The amount thereof shall be paid within twenty days after the date the notice was mailed, properly addressed to the person required to file the return required to be filed under this chapter at that person’s last known address.

(e) Limitation period. In the case of an audit commenced under this section, the amount of Hawaii transfer tax imposed by this chapter shall be assessed or levied within three years after the return was filed, or within three years of the due date prescribed for the filing of said return, whichever is later. In the case of a false or fraudulent return with intent to evade tax, or of a failure to file a return, the tax may be assessed or levied at any time; provided that the burden of proof with respect to the issues of falsity or intent to evade tax shall be upon the State. The limitation period shall be suspended if the person required to file the return agrees to suspend the period.”

New Partnership Audit Regime


The new regime’s major policy change is to require that partnerships must be audited and assessed at the partnership level and are responsible for payment of any additional tax due at the partnership level. The new regime includes an opt-out provision for partnerships with 100 or fewer partners.

The Department recommends conforming to the substance of the new partnership audit rules while maintaining the Department’s own timing and administrative provisions. This maintains the current policy of conforming to the substantive provisions of TEFRA, but not
conforming to the timing or administrative provisions of TEFRA. The Department’s specific recommendations are reflected in S.B. 2821, S.D. 1.

**Bipartisan Budget Act of 2018**

The “Bipartisan Budget Act of 2018”, P.L. 115-23, enacted on February 9, 2018, ended the second shutdown of the federal government during 2018. Additionally, it extended four expired federal tax provisions that are relevant to Hawaii income tax law. The Department recommends conforming to the IRC, as amended by this Act, to restore these provisions during this session in order to avoid gaps in conformity to these provisions.

The Bipartisan Budget Act of 2018 extended the following IRC provisions that are operative for Hawaii income tax purposes:

<table>
<thead>
<tr>
<th>Code Section</th>
<th>Description</th>
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<tbody>
<tr>
<td>108(a)(1)(E)</td>
<td>Discharge of indebtedness on principal residence excluded from gross income of individuals</td>
</tr>
<tr>
<td>163(h)(3)</td>
<td>Premiums for mortgage insurance deductible as interest that is qualified residence interest</td>
</tr>
<tr>
<td>168(e)(3)(A)</td>
<td>Three-year depreciation for race horses two years old or younger</td>
</tr>
<tr>
<td>179D(h)</td>
<td>Energy efficient commercial buildings deduction</td>
</tr>
</tbody>
</table>

To conform to the changes made by the Bipartisan Budget Act of 2018 the Department recommends that Section 2 of S.B. 2821, S.D. 1, be amended to amend section 235-2.3(a) to read as follows:

“235-2.3 Conformance to the federal Internal Revenue Code; general application. (a) For all taxable years beginning after December 31, [2016] 2017, as used in this chapter, except as provided in section 235-2.35, "Internal Revenue Code" means subtitle A, chapter 1, of the federal Internal Revenue Code of 1986, as amended as of [December 31, 2017] February 9, 2018, as it applies to the determination of gross income, adjusted gross income, ordinary income and loss, and taxable income, except those provisions of the Internal Revenue Code and federal public laws which, pursuant to this chapter, do not apply or are otherwise limited in application and except for the provisions of Public Law 109-001 which apply to section 170 of the Internal Revenue Code. The provisions of Public Law 109-001 to accelerate the deduction for charitable cash contributions for the relief of victims of the 2004 Indian Ocean tsunami are applicable for the calendar year that ended December 31, 2004, and the calendar year ending December 31, 2005.
Prior law shall continue to be used to determine:

(1) The basis of property, if a taxpayer first determined the basis of property in a taxable year to which prior law applies; and

(2) Gross income, adjusted gross income, ordinary income and loss, and taxable income for a taxable year to which prior law applies.”

Finally, the Department recommends the following technical corrections to the bill:

(1) Page 23, line 9: The reference to section 451(i)(3) and (6) should be changed to “section 451(j)(3) and (6).”

This change is needed due to a renumbering of the subsections in IRC section 451.

(2) Page 29, line 18: The date should be changed from “December 31, 2017” to “December 21, 2017.”

(3) Page 34, line 17 to page 35, line 6: replace current language with the following language:

“The return shall be filed, and the Hawaii transfer tax, including any additional tax that may become due, shall be paid by:

(1) the same person or persons, respectively, who are required to pay the federal transfer tax and file the federal return, including any duly authorized executor or administrator[\_\_] or

(2) if no federal transfer tax or federal return is due, the person who would be required to pay the federal transfer tax and file the federal return if any were due.”

This corrects a discrepancy between the original language offered to the Senate Committee on Ways and Means and the language ultimately used. The Department believes that as written in S.B. 2821, S.D. 1, the language imposes a payment obligation but not a filing obligation. The intent of the new language is to impose both a filing and a payment obligation.

(4) Page 37, line 2: “deter” should be changed to “defer.”

(5) Page 40, line 3: “and” should be included after “due.”

Thank you for the opportunity to provide testimony in support of this measure.