

**HB 2594,
HD2
Testimony**

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SENATE COMMITTEE ON WAYS & MEANS

TESTIMONY ON HB 2594 HD 2 RELATING TO CONFORMITY OF THE HAWAII INCOME TAX LAW TO THE INTERNAL REVENUE CODE

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)
DATE: MARCH 16, 2010
TIME: 10AM
ROOM: 211

The purpose of this bill is to amend Hawaii's income tax law to conform with the changes to the Internal Revenue Code (the "Code") made by Congress in 2009. As amended, this measure also conforms to federal law for interest payable out of the litigated claims fund for tax cases.

The Department of Taxation ("Department") **supports** this Lingle-Aiona Administration-sponsored bill.

Section 235-2.5(c), Hawaii Revised Statutes (HRS), mandates that the Department submit to each regular session of the Legislature a bill that amends Hawaii income tax law to conform to changes in the Code, for the previous calendar year.

I. SUMMARY OF THE CONFORMITY BILL

In 2009, Congress enacted tax measures with the hope of stimulating the economy and providing taxpayer relief. The tax measures that impact the state's conformity to the Internal Revenue Code are the American Recovery and Reinvestment Act of 2009 (P.L. 111-5), ("ARRA") enacted on February 17, 2009, and the Worker, Homeownership, and Business Assistance Act of 2009 (P.L. 111-92) ("WHBA") enacted on November 6, 2009. The enacted legislation ranged from providing incentives to invest in capital items (e.g., bonus depreciation, expensing of capital items), and providing relief to individual taxpayers (e.g., additional standard deduction, partial exclusion for unemployment compensation). As can be expected, the cost of conforming to the 2009 amendments to the Code is significant. As explained further below, generally, the Department recommends nonconformance for those provisions that we have consistently not conformed to in the past and for those provisions which cost the state money.

Section 2 of this bill amends section 235-2.3(a), HRS, to conform the Hawaii Income Tax Law to the operative Code sections of subtitle A, chapter 1, amended as of December 31, 2009. Generally, subtitle A, chapter 1, refers to Code sections 1 through 1400T. Section 2 also provides that with respect to the following sections of the Code:

- **§139C (COBRA premium assistance)** -- to not conform to the exclusion from gross income for a taxpayer's subsidy for continuation of COBRA coverage (ARRA provision); and
- **§853A (Credits from tax credit bonds allowed to shareholders)** -- to not conform to the pass-through of the credit from tax credit bonds to shareholders of Regulated Investment Companies and Real Estate Investment Trusts (ARRA provision);
- **§1400-U-1 (allocation of recovery zone bonds)** -- to not conform to national limitations on recovery zone bonds since does not effect Hawaii state tax (ARRA provision);
- **§1400U-2 (recovery zone economic development bonds)** -- to not conform to issuance of economic development bonds since does not effect Hawaii state tax (ARRA provision); and
- **§1400U-3 (recovery zone facility bonds)** -- to not conform to issuance of economic development bonds since does not effect Hawaii state tax (ARRA provision).

Section 3 of this bill amends section 235-2.4, HRS, with respect to conformity provisions for the following sections of the Code:

- **§63 (standard deduction)** -- to not conform to the addition of motor vehicle sales taxes to the standard deduction. This provision would allow individuals who cannot itemize deductions to deduct the general excise tax on a motor vehicle purchase as part of the standard deduction (ARRA provision);
- **§85 (unemployment compensation)** -- to not conform to the exclusion from gross income of up to \$2,400 of unemployment compensation benefits for 2009 (ARRA provision);
- **§108 (income from discharge of indebtedness)** -- to not conform to section 108(i), which provides that income from reacquisitions of business debt at a discount in 2009 and 2010 is deferred for up to five years, then included ratably over five years (ARRA provision);
- **§132 (fringe benefits)** -- to not conform to section 132(f)(2) that provides that the monthly exclusion for employer-provided transit passes and vanpooling benefits increased to same level as employer-provided parking for 2009 and 2010 (ARRA provision). In addition, to not conform to section 132(n) that provides an

income tax exclusion for United States Department of Defense Homeowners Assistance Program payments authorized by the ARRA (WHBA provision);

- **§163 (interest deduction)** – to not conform to section 163(i)(1) and 163(e)(5)(F), which relax interest deduction rules for applicable high-yield discount obligations to address distressed conditions in the debt capital markets (ARRA provision);
- **§164 (deduction for state and local taxes)** – to not conform to section 164(a)(6) and 164(b)(6), which provide an itemized deduction for general excise tax on sales of most new motor vehicles purchased on or after February 17, 2009 and before January 1, 2010 (ARRA provision);
- **§168 (depreciation)** – to not conform to the special allowances (e.g., bonus depreciation) for certain property. Hawaii has consistently not conformed to special allowance provisions (ARRA provision);
- **§179 (election to expense certain depreciable assets)** – to not conform to the increased maximum deduction and phaseout amounts for 2009 (as is consistent with historical practice) (ARRA provision);
- **§265 (expenses and interest related to tax-exempt income)** – to not conform to the expansion of tax-exempt interest safe harbors for banks and small issuers for obligations issued in 2009 and 2010 ("ARRA provision");
- **§382 (limitation on net operating loss carryforwards)** – to not conform to elimination of certain loss limitation rules for restructurings under the Troubled Asset Relief Program ("TARP") authorized by the Emergency Economic Stabilization Act of 2008 (ARRA provision);
- **§408A (Roth Individual Retirement Accounts)** – to not conform to section 408A(d)(3)(A)(iii) that provides for the ratable inclusion of the income from conversion of a traditional IRA to a Roth IRA over a 2-year period. For state tax purposes, the income would all be included in the year of conversion. This provision was enacted in 2006 but was not effective until 2010; and
- **§529 (tuition programs)** – to not conform to including computer technology equipment and internet access and related services as qualifying higher education expenses for section 529 college savings plans for 2009 and 2010. (ARRA provision).

Section 4 of this bill amends section 235-2.45, by clarifying that:

- **§1202 (exclusion for gain from certain small business stock)** – to not conform to the increase of the amount gain on the sale or exchange of qualified small business stock that noncorporate taxpayers can exclude from

50% or 60% to 75% (ARRA provision); and

- **§1374 (tax imposed on S-Corporation built-in gains)** – to not conform to the reduction of the built-in gain recognition period to 7 years from 10 years.

Section 5 of this bill amends section 235-7(d) by providing that the net operating loss carryback period for Hawaii state tax purposes will remain at 2 years. The bill specifically provides that Hawaii does not conform to the election to allow electing small businesses to carryback net operating losses up to 5 years for 2008, which was part of the ARRA, and the expansion of the 5-year carryback election to most businesses, not just small businesses, for 2009, which was part of the WBHA.

II. REVENUE IMPACT

It is estimated that the conformity bill will neither materially reduce or increase revenues, as explained further below. Given the current fiscal environment, the Administration proposes to not conform to any Internal Revenue Code change that would result in a negative impact to the general fund.

For most provisions, the Hawaii State revenue impact is obtained by adjusting the revenue estimate provided for the U.S. government by the Joint Committee on Taxation. Three adjustments are made. The first is for the size of Hawaii's economy, which is roughly one-half of one percent of the total U.S. gross domestic product. The second is for the difference in federal and Hawaii State effective tax rates. It is assumed that the State average effective tax rate is one-quarter of the federal for the Individual Income Tax and 18% of the federal for the Corporation Income Tax. The third is for the difference in fiscal years: the federal fiscal year ends September 30

The revenue impact for requiring the tax to be paid in one year (rather than two) for the conversions of traditional IRAs to Roth IRAs is approximately \$5,000,000 gain in FY 2011 and a \$5,000,000 loss in FY 2012.

The revenue impact for conforming to the Internal Revenue Code for purposes of interest payments out of the Litigated Claims fund for tax cases is approximately \$250,000 annually.

The attached chart summarizes the cost of the provisions of the ARRA and the WHBA that would have an impact on state tax revenue if Hawaii conformed to the Internal Revenue Code changes.

Revenue Cost of Conforming to the American Recovery and Reinvestment Tax Act of 2009

| | Provision | Effective date | JCT Cost (\$million) | | Adjust. Factor | Rev. Loss | |
|----|--|-----------------------------|----------------------|--------|----------------|---------------------|---------------------|
| | | | FY2009 | FY2010 | | (FY2010) 6/ | (FY2010) 7/ |
| 1 | Temporarily allow certain computer costs as qualified expense for qualified tuition programs | epoia 12/31/08 | negl. | negl. | na | negl. | negl. |
| 2 | Exclude up to \$2,400 of unemployment benefits for taxable year 2009 | tyba 12/31/08 | 948 | 3,216 | 1,250 | \$3,311,250 | \$5,205,000 |
| 3 | Sales tax deduction for new car purchases (up to \$49,500) 1/ | po/a DOE | 424 | 1,269 | 1,250 | \$1,322,188 | \$1,500,000 |
| 4 | Equalize tax-free transit and parking benefits, set both at \$230 in 2009 and index for inflation | mbo/a DOE | 57 | 106 | 1,250 | \$117,188 | \$203,750 |
| 5 | Income arising from reacquis. of bus. debt can be deferred and modification of rules for original issue discount on certain high yield obligations, including the rate used to determine whether the original issue discount is too 'high' | ra 12/31/08 & before 1/1/11 | 12,113 | 22,803 | 900 | \$18,117,450 | \$31,424,400 |
| 6 | COBRA health ins. subsidy excl. from taxable income 2/ | DOE | 14,302 | 9,154 | 25 | \$261,025 | \$586,400 |
| 7 | Scope of \$500,000 compensation deduction limit for TARP recipients is broadened | DOE | negl. | negl. | | negl. | negl. |
| 8 | Carryback period for 2008 net operating loss is increased to 3 to 5 years for electing small bus. | 3/ | 4,741 | 708 | 900 | \$1,544,625 | \$4,904,100 |
| 9 | Tax-exempt interest expense safe harbors for banks and small issuers expanded for 2009-2010 | 12/31/08-1/1/11 | 79 | 239 | 900 | \$179,100 | \$286,200 |
| 10 | S Corp built-in gain holding period shortened from 10 to 7 years for 2009 & 2010 | 4/ | 31 | 154 | 1,250 | \$154,063 | \$231,250 |
| 11 | Recovery zone facility bonds authorized for issuance in 2009 and 2010 | bib 1/1/11 | 175 | 313 | 1,250 | \$348,125 | \$610,000 |
| 12 | Noncorporate taxpayers can exclude 75% of gain on sale or exchange of stock in qualified businesses held for more than 5 years. | saa DOE | 2 | 6 | 1,250 | \$6,250 | \$10,000 |
| 13 | Grants for specific energy property in lieu of credits are excluded from taxable income 3/ | 12/31/08 to 1/1/11 | 30 | 88 | 640 | \$47,040 | \$75,520 |
| | TOTAL | | | | | \$25,361,263 | \$44,961,100 |

Revenue cost of conforming to certain provisions of the "Worker, Homeownership, and Business Assistance Act of 2009"

| | | JCT Cost (Smillion) | | Adjust. Factor | Revenue Loss | | |
|---|--|------------------------|----------|-------------------|--------------|--------------|--------------|
| | | FY2010 | FY2011 | | FY2011 6/ | FY2011 7/ | |
| 1 | Increase carryback period to five years for NOLs arising from 2008 or 2009 | 8/ | \$33,197 | 5,870 | 900 | \$11,431,575 | \$35,160,300 |
| 2 | Exclude payments made to compensate for housing losses to military personnel for base closings or realignments | Pmts after 2/17/09 | 119 | 41 | 1,250 | \$75,625 | \$200,000 |

1/ The change in liabilities is based on the JCT estimate, but the change in collections is based on an earlier assessment.

(See g:\data\trp\cy09\legis\djr.docx).

2/ Based on CBO estimates that roughly \$14.3 billion will be paid out in premiums in federal FY2009 and that \$9.2 billion will be paid out in premiums in federal FY2010, and that the marginal HI tax rate would be 5%.

3/ Effective for net operating losses generated in either a taxable year beginning in 2008 or a taxable year ending in 2008.

4/ Effective for taxable years beginning on or after 12/31/08 and ending before 1/1/11.

5/ CBO estimates that grants will total \$30 million in 2009 and \$88 million in 2010. The estimate assumes Hawaii has twice the renewable energy intensity as the rest of the country.

6/ Changes in tax liabilities incurred in the fiscal year.

7/ Changes in actual collections in the fiscal year assuming all revenue costs of the conformity in prior periods are incurred in the first six months of the fiscal year. (Also includes changes in tax liabilities in all of the prior fiscal year.)

8/ Generally effective for net operating losses arising in taxable years ending after December 31, 2007.

epoia = "expenses paid or incurred after"

tyba = "taxable years beginning on or after"

po/a = "purchases on or after"

DOE = "date of enactment" (= 17 February 2009)

mbo/a = "months beginning on or after"

bib = "bonds issued before"

ra = "repurchases after"

saa = "stocks acquired after"

TAXBILLSERVICE

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TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Conformity to federal code

BILL NUMBER: HB 2594, HD-2

INTRODUCED BY: House Committee on Finance

BRIEF SUMMARY: Amends HRS section 232-24 to provide that the interest rate on monies held by the litigated claims fund shall be the rate specified by IRC section 6621(a) (with respect to interest rate determination) as of January 1, 2010.

Amends HRS section 235-2.3(a) by changing the date references to make the Internal Revenue Code (IRC) applicable for state income tax purposes as it was amended on 12/31/09 for tax years beginning after 12/31/09.

The following sections of the Internal Revenue Code (IRC) shall **not** be operable for Hawaii income tax purposes: section 139C (with respect to COBRA premium assistance); section 853A (with respect to credits from tax credit bonds allowed to shareholders); section 1400U-1 (with respect to allocation of recovery zone bonds); section 1400U-2 (with respect to recovery zone economic development bonds); and section 1400U-3 (with respect to recovery zone facility bonds).

Amends HRS section 235-2.4(a) to provide that the following shall **not** be operative for Hawaii income tax purposes: section 63(c)(1)(E) (relating to the motor vehicle sales tax deduction; section 63(c)(9) (defining the motor vehicle sales tax deduction); provides that section 85 (with respect to unemployment compensation) shall be operative, except that section 85(c) shall **not** be operative; section 108 (with respect to income from discharge of indebtedness) shall be operative, except that section 108(i) (relating to deferral and ratable inclusion of income arising from business indebtedness discharged by the reacquisition of a debt instrument) shall **not** be operative; section 132 (with respect to certain fringe benefits) shall be operative, except that provisions in section 132(f)(2) that equalize the dollar amounts for 132(f)(2)(A) and (B) after February 17, 2009 and until January 1, 2011, shall **not** be operative and except that section 132(n) shall **not** apply to United States Department of Defense Homeowners Assistance program payments authorized by the American Recovery and Reinvestment Act of 2009; section 163(e)(5)(F) (suspension of applicable high-yield discount obligation rules), and section 163(i)(1) as it applies to debt instruments issued after 1/1/10 (defining applicable high-yield discount obligation), shall **not** be operative; section 164 (with respect to taxes) shall be operative for the purposes of this chapter, except that section 164(a)(6) and 164(b)(6) shall **not** be operative; Section 265 (with respect to expenses and interest relating to tax-exempt income) of the Internal Revenue Code shall be operative for purposes of this chapter; except that sections 265(b)(3)(G) and 265(b)(7) shall **not** be operative and section 265 shall **not** apply to expenses for royalties and other income derived from any patents, copyrights, and trade secrets by an individual or a qualified high technology business as defined in section 235-7.3-such expenses shall be deductible; section 382 (with respect to limitation on net operating loss carryforwards and certain built-in losses following ownership change) shall be operative for the purposes of this chapter, except that section 382(n) shall **not** be operative; section 408A (with respect to Roth Individual Retirement Accounts) shall be operative, except that section 408A(d)(3)(A)(iii) shall **not** be

operative; and section 529 (with respect to qualified tuition programs) shall be operative, except that section 529(c)(6) and section 529(e)(3)(A)(iii) shall **not** be operative.

Amends HRS section 235-2.45(a) to provide that: section 1202 (with respect to partial exclusion for gain from certain small business stock) shall be operative, except that section 1202(a)(3) shall **not** be operative; subchapter S (sections 1361 to 1379) (with respect to tax treatment of S corporations and their shareholders) of chapter 1 of the IRC shall be operative as provided in part VII; except that section 1374(d)(7)(B) and 1374(d)(7)(C) shall **not** be operative.

Amends HRS section 235-7(d) to provide that the election for the carryback for 2008 or 2009 net operating losses of small businesses as provided in IRC section 172(b)(1)(H), as it read on December 31, 2009, shall **not** be operative.

EFFECTIVE DATE: Upon approval

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-1 (10) in compliance with HRS section 235-2.5 which requires the department to annually submit a measure to maintain state income tax conformity with the federal Internal Revenue Code. The purpose of conformity is to update the state income tax laws with respect to the definition of income with those changes made to the federal Code during the past year and to adopt those changes that are appropriate for Hawaii law.

For those unfamiliar with the operation of the conformity statute, the federal Code is adopted by exception, that is Chapter 1 of subtitle A of the Internal Revenue Code is adopted with the exception of the various Code sections listed in HRS section 235-2.3. Thus, if the Code section is not listed there, it is operative for state income tax purposes. In some cases, Code sections are operative with certain limitations as noted in HRS sections 235-2.4 and 2.45 where provisions like the standard deduction are operative, but the state law inserts different amounts for state income tax purposes. Prior to the adoption of the current statute in 1978, changes to the federal Code were adopted by referencing the specific Public Laws of the various sessions of Congress that made those changes. This was a tedious and cumbersome way to adopt the changes to the federal Code as one had to have the specific Public Law in order to understand how a certain tax provision applied for state income tax purposes.

The **major** federal tax laws from which the provisions are adopted include: (1) American Recovery and Reinvestment Act of 2009 (ARRA) (P.L. 111-005); (2) Consumer Assistance to Recycle and Save Act of 2009 (P.L. 111-032); and (3) Worker, Homeownership, and Business Assistance Act of 2009 (P.L. 111-092).

Some of the IRC provisions **not** adopted: (1) the federal exclusion from gross income of the COBRA subsidy under IRC section 139C as added by ARRA which provides an exclusion from federal gross income for a 65% subsidy for COBRA continuation premiums for up to 9 months for certain workers who have been involuntarily terminated and for their families; (2) ARRA allows certain regulated investment companies (RIC) to elect to: (a) forego tax credits on any tax credit bonds that a RIC holds during any year in which an election is in effect; (b) include in income as interest the amount of income it would have included with respect to such credits if no election were in effect; and (c) increase its dividends paid deduction by the amount of such income. If the election is made, each shareholder of the RIC is required to include in gross income the shareholder's proportionate share of the interest income attributable to the credits and is allowed to take such proportionate share as a credit against the

shareholder's income; (3) ARRA allows an issuer of Build America Bonds to designate the bonds as recovery zone economic development bonds if the entire excess of available project proceeds over the amounts in a reasonably required reserve and are used to promote economic activity in an area of substantial poverty, high unemployment, or other general distress. In the case of Build America Bonds designated as recovery zone economic development bonds, the issuer receives a credit of 45% of any interest payments made on the bonds. The credit to the issuer would be in lieu of the credit to the holder of the bonds and would be paid to the issuer contemporaneously with the payment of the related interest; (4) ARRA would add to the list of exempt facility bonds a new class known as recovery zone facility bonds (IRC § 1400U-3) for 2009 and 2010 - to qualify, the bonds must direct almost all proceeds toward property used in a trade or business that is constructed, purchased, or renovated after the location of the property is classified as a recovery zone; (5) under ARRA up to \$2,400 of unemployment compensation benefits received in 2009 may be excluded from the gross income; (6) a new above-the-line deduction for sales tax paid on qualified motor vehicles with a maximum purchase price of \$49,500 purchased in 2009; (7) ARRA allows "529 plans" to make tax-free distributions for the purchase of computers and internet access expenses; and (8) extends through 2009 the bonus depreciation rules which permit taxpayers to take a deduction equal to 50% of the adjusted basis of certain depreciable property in the year in which such property is placed into service and extends through 2009 the increased limits on the expensing of certain depreciable assets under IRC section 179 currently in place for 2008.

Among the provisions that are being made operative for Hawaii income tax purposes include the provision in which ARRA allows a business to defer, until 2014, cancellation of indebtedness income arising in 2009 or 2010 from a repurchase, for cash, of a debt instrument that was issued by the taxpayer; however, after the deferral period, the provision that the business must recognize the deferred income ratably over the next five years is not operable for Hawaii income tax purposes;

It should be noted that a number of Code amendments last year focused on incentives to help jump start the economy with a variety of tax credits. Generally, Hawaii does not adopt these tax credits for state income tax purposes as these credits are a direct reduction of tax liability. Since federal tax rates are higher than state income tax rates, these credits are usually much more generous than what Hawaii can afford.

The proposed measure would also provide that the rate of interest rate of monies in the litigated claims fund shall be the rate as specified under IRS section 6621(a) (with respect to interest rate determination) as of January 1, 2010, rather than the current rate of 8% per year. While the committee report states that the interest rate under the proposed measure would be 3%, under the federal provision, the rate is the sum of: (1) the federal short-term rate; and (2) 3 percentage points. So if the proposed measure is adopted, it would appear that as of January 1, 2010, the rate would be 3.57%. If it is the intent of the legislature to set the rate of interest at 3%, then the correct reference should be IRC section 6621(a)(2)(B).

While the proposed measure provides that it shall take effect upon approval and provides that section 5 of the measure shall take effect on January 1, 2011, it is questionable why section 5, that provides that the motor vehicle sales tax deduction shall not be operable for Hawaii income tax purposes, is singled out as that provision is also contained in section 4. More importantly, it should be noted that tax changes for Hawaii are usually adopted for a tax year to insure compliance and simplicity of administration and this measure should not be enacted with an "upon approval" effective date.