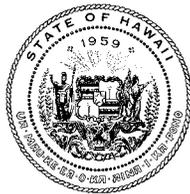


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SENATE COMMITTEE ON WAYS & MEANS

TESTIMONY ON SB 2747 SD 1 RELATING TO CONFORMITY OF THE HAWAII INCOME TAX LAW TO THE INTERNAL REVENUE CODE

TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)

DATE: FEBRUARY 22, 2010

TIME: 10:20AM

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.

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 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

Department of Taxation Testimony

February 22, 2010

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

			JCT Cost (\$million)		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\dj.r.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"

TESTIMONY SUBMITTED BY



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COMMITTEE ON WAYS AND MEANS

Senator Donna Mercado Kim, Chair

Senator Shan S. Tsutsui, Vice Chair

SB 2747 SD1

RELATING TO CONFORMITY OF THE HAWAII INCOME TAX LAW TO THE INTERNAL REVENUE CODE

February 22, 2010 10:20AM

State Capitol

Conference Room 211

415 South Beretania Street

Honolulu, HI 96813

Support for SB 2747 SD1 – RELATING TO CONFORMITY OF THE HAWAII INCOME TAX LAW TO THE INTERNAL REVENUE CODE

Executive Summary

My name is Joseph Saturnia and I am President of Island Pacific Energy, the leading developer, owner operator of photovoltaic renewable energy facilities in the State of Hawai'i. I am testifying on behalf of Island Pacific Energy in support for SB 2747 SD1- RELATING TO CONFORMITY OF THE HAWAII INCOME TAX LAW TO THE INTERNAL REVENUE CODE.

We ask the committee to correct a situation where a non-taxable Federal incentive for renewable energy is being inadvertently taxed by the State of Hawaii.

Incentives for Renewables

In order to encourage development of renewable energy, the Federal government offers an Investment Tax Credit of 30% of the cost for renewable energy systems. The Investment Tax Credit is not subject to tax on the Federal or State level. As part of the American Recovery and Reinvestment Act of 2009, the Federal government created a 30% Treasury Grant as an alternative to the 30% Investment Tax Credit. The Treasury Grant is an alternative for those developers who have difficulty monetizing the Investment Tax Credit. Similar to the Investment Tax Credit, the Treasury Grant is not taxable for Federal income tax purposes. Unfortunately, due to an unintended consequence in the wording of Hawaii's 2008 conformity law, the Treasury Grant is subject to taxation by the State of Hawaii.

The 2008 Hawaii conformity code excludes section 48 of the Internal Revenue Code to (among other reasons) facilitate the 35% State Tax Credit. Unfortunately, the Federal provision that exempts the Treasury Grant from taxation was inserted in section 48(d)(3)(A) which is part of the broad exclusion in the Hawaii 2008 conformity code. The broad exclusion of section 48 of the Internal Revenue Code creates the unintended consequence of taxing the Federal Treasury Grant when its counterpart, the Investment Tax Credit is not taxable at the State level.

Unintended Law Discourages Renewable Energy Development in Hawaii

The unintended consequence of Hawaii's 2008 conformity law discourages renewable energy development in the State of Hawaii. Renewable energy projects operate on thin profit margins. By adding the additional unexpected tax on the Treasury Grant, many developers are forced to forego the Treasury Grant in favor of the non taxable Investment Tax Credit or forego their renewable energy project altogether.

In lieu of this situation, we respectfully request the committee add the following highlighted language into SB 2747 SD1 to restore the intended tax free status of the Treasury Gant and maintain our State's commitment to renewable energy.

Section 2

(1) Subchapter A (sections 1 to 59A) (with respect to determination of tax liability), except section 1(h) (2) (relating to net capital gain reduced by the amount taken into account as investment income), except sections 2(a), 2(b), and 2(c) (with respect to the definition of "surviving spouse" and "head of household"), except section 41 (with respect to the credit for increasing research activities), except section 42 (with respect to low-income housing credit), [and] except sections 47 and 48, as amended, as of December 31, 1984 (with respect to certain depreciable tangible personal property) **and except section 48(d)(3)(A), as amended, as of January 1, 2009.**

Conclusion

An unintended consequence of the 2008 State of Hawaii conformity law has caused an otherwise non-taxable incentive for renewable energy to be taxed. By inserting corrective language into SB 2747 SD1 we can correct the situation and restore the tax free status of the Federal Treasury Grant. Mahalo for the opportunity to testify.

Joseph Saturnia

President

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About Island Pacific Energy

Island Pacific Energy is the leading developer, operator of photovoltaic solar energy facilities in the State of Hawai'i and is the recipient of the Governor's Award for Innovation. Island Pacific Energy makes renewable energy systems affordable to Hawaiian consumers, businesses, government, and not-for-profit organizations. For more information, please visit www.islandpacificenergy.com.

TAXBILLSERVICE

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TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Conformity to federal code

BILL NUMBER: SB 2747, SD-1; HB 2594, HD-1 (Identical)

INTRODUCED BY: SB by Senate Committee on Ways and Means; HB by House Committee on Finance

BRIEF SUMMARY: 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 be operative** for Hawaii income tax: section 63(c)(1)(E) (relating to the motor vehicle sales tax deduction; section 63(c)(9) (defining the motor vehicle sales tax deduction); 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 January 1, 2010 (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 that [it] 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.

Digested 2/19/20