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HOUSE COMMITTEE ON FINANCE

TESTIMONY ON HB 3191 HD 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 26, 2008
TIME: 10:00AM
ROOM: 308

The purpose of this bill is to amend Hawaii's income tax law to conform with the changes to the Internal Revenue Code made by Congress in 2007.

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 the changes in the Internal Revenue Code (IRC), for the previous calendar year.

Digests of the 2007 federal laws to be considered as conformity items have been provided to the Committee prior to this hearing. These digests discuss the operative and non-operative amendments of the Internal Revenue Code in more detail.

The adoption of the amendments to the IRC sections assures continued State conformity with federal income tax law and minimizes taxpayers' burdens in complying with Hawaii's income tax law.

Section 1 of this bill amends section 235-2.3(a), HRS, to conform the Hawaii Income Tax Law to the operative IRC sections of subtitle A, chapter 1, amended as of December 31, 2007. Generally, subtitle A, chapter 1, refers to the IRC sections 1 through 1400T.

Section 2 of this bill amends section 235-2.4(g), HRS, to provide that the State will not increase the maximum section 179 expense deduction to \$125,000 from the current state maximum deduction of \$25,000 or increase the qualifying investment amount to \$500,000 from the current state qualifying investment amount of \$200,000 for taxable years 2007 through 2010.

Section 3 of this bill amends section 235-2.45(g), HRS, to make non-operative for Hawaii income tax purposes section 1400N(c) (relating to special rules for the low-income housing credit for low-income housing constructed in the Gulf Coast areas affected by Hurricanes Katrina, Rita, and Wilma). While section 1400N(c) was enacted in 2005 and has been operative for Hawaii income tax purposes, section 1400N(c) has no real effect in Hawaii because for Hawaii income tax purposes the low-income housing credit as provided in HRS section 235-110.8 only applies to low-income housing located in Hawaii. To avoid confusion, the Department believes that section 1400N(c) should no longer be operative.

Section 4 of this bill amends section 235-55.91(c), HRS, to add to the definition of vocational rehabilitation referral to conform to the definition in section 51 of the Internal Revenue Code.

The following is a description of the new federal acts that were passed by Congress in 2007 that amended the Internal Revenue Code:

1. The Small Business and Work Opportunity Act of 2007. (P. L. No. 110-28; May 25, 2007):

The amendments to operative provisions include: certain pension rule amendments; allowing a deduction for the interest on debt used to acquire S Corporation stock by an Electing Small Business Trust; allowing certain partnerships consisting of only a husband and wife to file a joint return instead of a partnership return; treating sale of stock in a Qualified Chapter S Subsidiary as a sale of a portion of the assets; not taking into account restricted bank director stock in determining S Corporation qualification; and S Corporation capital gains are not treated as passive investment income under the S Corporation rules.

2. The Andean Trade Preference Act. (P. L. No. 110-42; June 30, 2007):

This Act only amends non-operative provisions.

3. The Joint Resolution Approving the Renewal of Import Restrictions Contained in the Burmese Freedom and Democracy Act of 2003. (P. L. No. 110-52; August 1, 2007).

This Act only amends non-operative provisions.

4. To Extend the Trade Adjustment Assistance Program Under the Trade Act of 1974. (P. L. No. 110-89; September 28, 2007):

This Act only amends non-operative provisions.

5. To Implement the United States-Peru Trade Promotion Agreement. (P. L. No. 110-138; December 14, 2007):

This Act only amends non-operative provisions.

6. Energy Independence and Security Act of 2007. (P.L. 110-140; December 19, 2007):

The only operative provision of this Act extends the amortization period of geological and geophysical costs for major integrated oil companies from five years to seven years.

7. 2007 Virginia Tech Victims Act. (P.L. 110-141; December 19, 2007):

The operative provision of this Act excludes from gross income certain payments received by surviving victims and survivors of slain victims of the Virginia Tech shootings.

8. Mortgage Forgiveness Debt Relief Act of 2007. (P.L. 110-142; December 20, 2007):

The amendments to operative provisions include: clarification of low-income housing tax credit rule regarding full-time students; exclusion from gross income of up to \$2 million of cancellation of indebtedness income where debt relates to acquisition of a principal residence; clarifies exclusion amounts applicable to gain from the sale of a principal residence where a spouse is deceased on the date of sale; provides a new exclusion from gross income for qualified state or local tax benefits or payments received in exchange for services provided as members of qualified volunteer emergency response organizations; extension of interest deduction for mortgage insurance premiums until 2010; and two alternative tests for qualifying as a cooperative housing corporation.

9. Tax Increase Prevention Act of 2007. (P.L. 110-166; December 26, 2007):

This Act only amends non-operative provisions.

10. Consolidated Appropriations Act, 2008. (P.L. 110-161; December 26, 2007):

This Act only amends non-operative provisions.

11. Tax Technical Corrections Act of 2007. (P.L. 110-172; December 29, 2007):

This Act makes clarifying or purely technical amendments to the Internal Revenue Code, such as correcting erroneous cross-references.

Revenue Impact

It is estimated that the conformity bill would reduce income tax revenues at an annual rate of about \$506,000 in fiscal year 2009 and after.

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 ½ of one percent of the total U.S. GDP. 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 effects are estimated for annual rates in fiscal year 2008.

The following provisions were deemed to have more than a negligible effect on Hawaii State income tax collections:

"Mortgage Forgiveness Debt Relief Act of 2007" (P.L. No. 110-142, December 20, 2007), - \$473,000.

Discharge up to \$2 million of acquisition debt on taxpayer's principal residence in 2007-2009 are excluded from income; -\$280,000.

Tax relief and expense reimbursements provided by state and local governments to volunteer firefighters and emergency medical responders for services performed are tax-free for 2008-2010 tax years; -\$86,000.

Interest deduction for mortgage insurance premiums is extended to amounts paid or incurred after 2007 and before 2011; -\$107,000.

"The Small Business and Work Opportunity Tax Act of 2007" (P.L. No. 110-28, May 25, 2007), - \$33,000.

S corporation capital gains are not treated as passive income; -\$33,000.

"The Tax Technical Corrections Act of 2007" (P.L. No. 110-172, December 29, 2007)

No appreciable revenue impact.

L E G I S L A T I V E

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SUBJECT: INCOME, Conformity to federal Code

BILL NUMBER: HB 3191, HD-1

INTRODUCED 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 12/31/06 for tax years beginning after 12/31/07.

Amends HRS section 235-2.4(g) to provide that IRC section 179 (with respect to the election to expense certain depreciable business assets): (1) the maximum deduction shall be increased to \$125,000 for taxable years beginning after 2006 and before 2011; and (2) the qualifying investment amount shall be increased to \$500,000 for tax years beginning after 2006 and before 2011 for Hawaii income tax purposes.

Amends HRS section 235-2.45 to provide that IRC section 1400N (c) with respect to the low-income housing credit shall not be operative for Hawaii income tax purposes.

Amends HRS section 235-55.91 to amend the definition of "vocational rehabilitation referral" to also mean an individual who has been certified by the department of human services vocational rehabilitation and services for the blind division in consultation with the Hawaii state employment service of the department of labor and industrial relations as having been referred to the employer upon completion of rehabilitative services pursuant to an individual work plan developed and implemented by an employment network pursuant to subsection (g) of section 1148 of the Social Security Act, as amended.

Provides that the retroactive and prospective effective dates contained in the congressional acts relating to the Internal Revenue Code and enacted during 2007 shall be operative for HRS chapter 235.

EFFECTIVE DATE: Tax years beginning after December 31, 2007

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-06(08) 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 to Hawaii law.

The changes this measure adopts are those included in the: (1) Tax Technical Corrections Act of 2007 (P.L. 110-172); (2) Tax Increase Prevention Act of 2007 (P.L. 110-166); (3) Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142); and (4) Small Business and Work Opportunity Tax Act of 2007 (Title VIII of P.L. 110-28).

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The proposed measure increases IRC Section 179 expensing through 2010 and increases Section 179's dollar amount from \$100,000 to \$125,000 for tax years beginning after 2006. It also increases the Section 179 investment limitation from \$400,000 to \$500,000 for tax years beginning after 2006. These amendments are a result of adopting amendments made by the Small Business and Work Opportunity Act of 2007.

Other provisions adopted for state income tax purposes include:

(1) the forgiveness of debt, which occurs when a lender forgoes repayment of principal and/or interest the borrower owes. Typically, discharged debt is considered ordinary income to the borrower for income tax purposes. The new law allows taxpayers to exclude this amount and thus escape the tax liability.

Homeowners will have a three-year window to refinance their mortgage and pay no taxes on any debt forgiveness that they receive: (a) as long as the debt must have been discharged by the lender in 2007, 2008 or 2009; (b) the amount of debt that can be excluded is limited to \$2 million; (c) the exclusion can be used only if the loan was taken out to acquire, build or substantially improve a principal residence;

(2) extends a one-year deduction of mortgage insurance premiums that was effective in 2007 for three more years, until 2010, on loans that were originated after Dec. 31, 2006, and before Jan. 1, 2011 provided the full deduction is available only to taxpayers whose adjusted gross income is less than \$100,000. A partial deduction is allowed for taxpayers with adjusted gross incomes up to \$109,000;

(3) allows a surviving spouse to claim the \$500,000 if the home is sold within two years after the date of the spouse's death;

(4) a clarification of the deduction limits for S corporation shareholders where the S corporation contributes appreciated property;

(5) a correction of an error in present law for determining the foreign earned income exclusion in the case where a taxpayer has net capital gains in excess of taxable income;

(6) expands the preparer penalties to apply to all types of returns, and not just to income tax returns - if a tax preparer understates a taxpayer's tax liability and claims an "unreasonable position," the penalty is the greater of \$1,000 or 50% of the income derived by the preparer with respect to the return. This may be increased to the greater of \$5,000 or 50% of the income derived by the preparer with respect to the return if there is a willful or reckless disregard of the law. This provision is effective for returns prepared after May 25, 2007;

(7) if a claim for a refund or credit is made for an excessive amount, an accuracy-related penalty of 20% of the excessive amount is assessed on the person making the claim (either the preparer or taxpayer), applicable to any claim filed after May 25, 2007.

The conformity statute, as written today, is a far cry from the way the state adopted changes to the Internal Revenue Code prior to 1978 when the changes were adopted by referencing the Public Law making the change. Practitioners can now assume that everything not listed in HRS section 235-2.3 of sections not operative for state tax purposes is applicable to the definition of income for state tax purposes.

HB 3191, HD-1 - Continued

There have been numerous proposals in recent years, as well as during this session, that recommend providing for unique exemptions and deductions that affect the definition of income. If all of these proposals were adopted, Hawaii would once more fall out of conformity with the federal code creating numerous differences between the two laws that would require taxpayers to constantly be aware of those differences. This is the major reason that the legislature back in 1977 and decided that maintaining close conformity with the federal definition of income was important to minimize difficulties and reduce costs of compliance. Perhaps lawmakers should revisit the issue of conformity and the ease that it brings to taxpayers and administrators in complying with and administering the state income tax law.

It is curious that this measure adopts the federal effective dates. Tax changes for Hawaii are usually adopted for a tax year to insure compliance and simplicity of administration while IRS 235-2.5(a)(3) addresses retroactive provisions in federal public laws recognizing that the specified dates in the federal Code shall be operative.

Digested 2/25/08