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SENATE COMMITTEE ON WAYS & MEANS

TESTIMONY REGARDING SB 591 SD2 RELATING TO TAXATION

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

DATE: FEBRUARY 25, 2008

TIME: 10:30AM

ROOM: 211

The Committee on Economic Development & Taxation amended this bill by dividing the credit into parts for ease of administration. The Committee also amended the existing function of the Capital Goods Excise Tax Credit (credit) by allowing computer software to be claimed.

The Department of Taxation (Department) supports this legislation.

I. THIS IS THE DEPARTMENT'S RESPONSE TO SCR 115, SLH 2007.

Senate Concurrent Resolution 115, Session Laws of Hawaii 2007, requested that the Department "redraft the capital goods excise tax credit to remedy old references to repealed law." This bill represents the Department's response to that request. As amended, this bill sets forth the credit in separate parts within Chapter 235.

II. SUBSTANTIVE AMENDMENTS FOR SOFTWARE

In its original form, this bill made no substantive amendments to the capital goods excise tax credit. The Committee on Economic Development & Taxation amended this bill by substantively extending the credit to apply to computer software, as defined in the bill. The Department supports these amendments to clarify the erroneous positions taken by taxpayers and practitioners that the capital goods excise tax credit is allowable for software under current law. Contrary to federal cases referenced in the committee report, the Department has successfully defended that computer software is disallowed under the current credit regime before the administrative Board of Review. Though taxpayers are consistently appealing this matter, the Department acknowledges the intent of extending the credit to computer software and the legislative necessity to do so.

III. AMEND CROSS REFERENCES

The Department initially asked that the credit be redrafted under its existing section. The Department notes that many cross-references to Section 235-110.7 will need to be changed under this proposal.

For example, the Department suggests amending HRS § 235-2.3, which impacts conformity components to the Internal Revenue Code, as follows:

(b) The following Internal Revenue Code subchapters, parts of subchapters, sections, subsections, and parts of subsections shall not be operative for the purposes of this chapter, unless otherwise provided:

- (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), and 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)~~]. For treatment, see sections 235-110.91[, 235-110.7,] and 235-110.8;

VII. REVENUE IMPACT.

It is estimated that the revised bill would reduce tax revenues by \$965,000 in FY 2009 and thereafter. The impact of the capital goods excise tax credit was determined from the 2002 gross receipts of 'Computer and Software Stores.' Software was assumed to account for 25% of gross receipts.

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February 22, 2008

The Honorable Rosalyn H. Baker, Chair
Senate Committee on Ways and Means
State Capitol, Room 210
415 South Beretania Street
Honolulu, Hawaii 96813

RE: S.B. 591, S.D. 2, Relating to Taxation
Hearing Date: February 25, 2008 @ 10:30 a.m., Room 211

I am Craig Hirai, a practicing certified public accountant, who was a practicing tax attorney when I served as the Chair of the 2001-2003 Tax Review Commission. I am submitting this testimony in **support of S.B. 591, S.D. 2**, which repeals and reenacts the capital goods excise tax credit in order to reflect the definitions and other references to the Internal Revenue Code of 1954, as amended.

I would respectfully request that you note that Part II, Section K, Item 1, of the Report of the 2001- 2003 Tax Review Commission reads as follows:

1. Overhaul and Update the Capital Goods Excise Tax Credit.

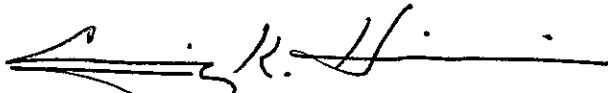
The four percent capital goods excise tax credit was originally enacted in 1987. The effect of the credit is essentially to refund the GET and Use Tax paid on capital goods by businesses.

The credit was designed to alleviate the cost of acquiring capital goods which has long been acknowledged to be important for the creation of jobs, and was patterned after the federal investment tax credit with references to former IRC §§38 and 48, which have now been repealed for over ten years. As a result, administration and compliance with the provisions of the capital goods excise tax credit have been less than forthright. Recent interpretations of the credit have resulted in applications that may stray from the original intent and letter of the former Federal statutes.

The Commission therefore recommends that HRS §235-110.7 be revised or rewritten as a whole to provide contemporary definitions and provisions under State law, rather than relying on outdated Federal statutes.

I believe that S.B. 591, S.D. 2, is consistent with the above recommendation, and I therefore urge you to pass this bill.

Mahalo for the opportunity to testify.

A handwritten signature in black ink, appearing to read "Craig K. Hirai", written over a horizontal line.

Craig K. Hirai, CPA/ABV, MBA, LLM

L E G I S L A T I V E

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SUBJECT: INCOME, Capital goods excise tax credit

BILL NUMBER: SB 591, SD-2

INTRODUCED BY: Senate Committee on Economic Development and Taxation

BRIEF SUMMARY: Adds a new part to HRS chapter 235 to recodify the capital goods excise tax credit with updated references to the Internal Revenue Code.

Repeals HRS section 235-110.7.

EFFECTIVE DATE: Tax years beginning after December 31, 2008

STAFF COMMENTS: The 2007 legislature adopted Senate Concurrent Resolution No. 115 which requested the department of taxation to "redraft the capital goods excise tax credit to remedy old reference to the repealed law and to incorporate the current status of the Internal Revenue Code." It should be noted that the capital goods excise tax credit was originally adopted in recognition that the general excise tax imposed on capital goods made the purchase of goods, that are imperative to the creation of new jobs and greater efficiency and productivity, all that more costly. Thus, the refund of the tax was viewed as mitigating the burden of the tax on the goods and equipment essential to the creation of new jobs.

While the resolution further requested the department of taxation to submit proposed legislation to the 2008 legislature, it appears that the initial submission by the department of taxation was a very preliminary draft which not only updates references to the Internal Revenue Code but also appears to incorporate the administrative rules of the capital goods excise tax credit. While the intent of the resolution was to make the capital goods excise tax credit easier to comply with by practitioners and certified public accountants, as proposed, it appears that the adoption of this draft would complicate compliance with the capital goods excise tax credit.

While the committee report submitted with the previous SD-1 acknowledged that it was a "work in progress" it should be noted that the department of taxation has had a little more than six months to comply with the resolution, perhaps more time is necessary to produce an updated capital goods excise tax credit law that is easy with which to comply. For example, in this draft of the bill, the drafters apparently have decided to not address one of the more controversial issues of the current credit and that is the definition of the "cost." It appears the drafters have decided to deal with the problem by merely deleting a definition of "cost" altogether. But that will not work because the term "cost" is essential to the definition of basis from which the credit is then determined.

Finally, with more than a year of administering the county surcharge of 0.5% making the general excise tax rate 4.5% in Honolulu, the department offers the credit in this bill at the rate of 4%. If the concern is that to refund the full amount of a 4.5% rate is that the state would be subsidizing the city by refunding

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an amount that has already been paid over to the city, the state should withhold an amount equal to what was claimed by taxpayers for the half percent surcharge from its payments to the city & county of Honolulu. Repaying back only a portion of what was levied on capital goods runs counter to the intent and purpose of the capital goods excise tax credit.

Digested 2/22/08