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## HOUSE COMMITTEE ON FINANCE

### TESTIMONY REGARDING HB 1153 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: MARCH 2, 2009**  
**TIME: 4:44PM**  
**ROOM: 308**

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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 2008.

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.

Digests of the 2008 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 Code in more detail.

#### **I. SUMMARY OF THE CONFORMITY BILL**

In 2008, Congress enacted several significant tax measures with the hope of stimulating the economy and providing taxpayer relief. The enacted legislation ranged from providing incentives to invest in capital items (e.g., bonus depreciation, expensing of capital items), providing relief to victims of natural disasters, and providing relief to individual taxpayers (e.g., additional standard deductions, mortgage debt relief). As can be expected, the cost of conforming to all of the 2008 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 for which there are other means to provide taxpayer relief.

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, 2008. Generally, subtitle A, chapter 1, refers to Code sections 1 through 1400T.

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 standard deductions for real property taxes and disaster losses; as well as to re-organize subparagraph (a). The standard deduction for real property taxes and disaster losses benefits taxpayers who do not itemize their deductions. Conformance with the real property tax deduction would result in providing state tax relief for a county tax. Conformance with the additional standard deduction for disaster losses may be costly if Hawaii had a federally declared disaster. If, in fact, a federally declared disaster occurs in Hawaii, the State could provide other tax relief (e.g., tax credit) at that time when the cost of such tax relief is more readily ascertainable.
- §165 (losses) – to not conform to the special provisions for federally declared disaster losses. If, in fact, a federally declared disaster occurs in Hawaii, the State could provide other tax relief (e.g., tax credit) at that time when the cost of such tax relief is more readily ascertainable.
- §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.
- §172 (net operating losses) – to not conform to the net operating loss provisions for federally declared disaster losses. If, in fact, a federally declared disaster occurs in Hawaii, the State could provide other tax relief (e.g., tax credit) at that time when the cost of such tax relief is more readily ascertainable.
- §179 (election to expense certain depreciable assets) – to not conform to the increased maximum deduction and phaseout amounts for 2008 (as is consistent with historical practice), and to not conform to the special rules for qualified disaster assistance property.
- §198A – to not conform to this new code section, which allows a current deduction (rather than requiring capitalization) of qualified disaster expenses. If, in fact, a federally declared disaster occurs in Hawaii, the State could provide other tax relief (e.g., tax credit) at that time when the cost of such tax relief is more readily ascertainable.
- §451 (general rule for taxable year of inclusion) – to not conform to deferred gain provisions for qualified electric utilities due to the cost of conformance.

Section 4 of this bill amends section 235-2.45, by clarifying that, although §1221 (capital asset defined) is operative, Hawaii will not conform to the ordinary gain or loss treatment for gain or loss from the sale or exchange of preferred stock in Federal National Mortgage Association or Federal Home Loan Mortgage Corporation by certain financial institutions.

## **II. SUMMARY OF FEDERAL ACTS AFFECTING THE CODE**

The following describes the federal acts that were passed by Congress in 2008 that amended the Code:

### **A. Economic Stimulus Act (P. L. No. 110-85, February 13, 2008):**

This Act amends operative provisions related to the depreciation of cellulosic biomass ethanol plant property and New York Liberty Zone property.

### **B. Heroes Earnings Assistance and Relief Tax Act of 2008 (P. L. No. 110-245, June 18, 2008):**

This Act amends operative provisions of the Code as follows: relaxes the ownership and use exceptions for intelligence community employees and members of the Peace Corps with respect to the exclusion of gain from the sale of a principal residence; allows unused health flexible spending account balances to be distributed to reservists called to active duty; clarifies that state bonus payments to service members constitute qualified military benefits that are excluded from gross income; includes differential wage payments received by uniformed service members in compensation for purposes of the IRA contribution limit and for retirement plan purposes; requires qualified retirement plans to provide survivor payments for veterans; and allows military death gratuities and proceeds from Servicemembers' Group Life Insurance to be contributed to Roth IRAs or rolled over to Coverdell education savings accounts, regardless of contribution limits.

### **C. Heartland, Habitat, and Horticulture Act of 2008 (P. L. 110-246, June 18, 2008):**

This Act provides relief to individuals affected by disasters in the Kansas area by relaxing certain retirement plan rules related to distributions, recontribution of withdrawals, loans, and plan amendments; extending the replacement period for involuntarily converted property; allowing taxpayers to expense certain costs incurred in the Kansas disaster area; and extending the net operating loss carryback period to five years for losses incurred in the Kansas disaster area. The Act also does the following: extends increased limits on qualified conservation contributions, allows farmers to deduct endangered species recovery expenditures, and relaxes rules relating to investments by a real estate investment trust in timber.

**D. Housing Assistance Tax Act of 2008 (P. L. 110-289, July 30, 2008):**

This Act amends operative provisions of the Code as follows: provides a minimum 9% applicable percentage for purposes of computing the low income housing tax credit; increases states' allocation authority for low income housing tax credits from \$2/resident to \$2.20/resident; amends other provisions relating to qualification and administration of low income housing projects; taxes gain allocated to periods of nonqualified use with respect to a sale of a principal residence; and relaxes rules regarding investment in foreign investments and health care facilities for real estate investment trusts.

**E. Hubbard Act (P. L. 110-317, August 29, 2008):**

This Act repeals the dollar limitation on contributions to qualified funeral trusts.

**F. Emergency Economic Stabilization Act of 2008 (P. L. 110-343, October 3, 2008):**

This Act extends the exclusion for debt discharge income from home mortgages. It also caps executive compensation and applies golden parachute rules to certain employers that participate in the Troubled Asset Relief Program.

**G. Energy Improvement and Extension Act of 2008 (P. L. 110-343, October 3, 2008):**

The operative provisions of this Act provide as follows: establishes qualified transportation fringe benefits for bicycle commuters; designates "Smart" electric meters and distribution grid systems as 10-year modified accelerated cost recovery system property; includes property used to produce any cellulosic biofuel as property eligible for bonus depreciation; extends election to expense certain refineries; extends deduction for energy efficient commercial building property; modifies provisions relating to qualifying electric transmission transactions; applies valuation conventions for determining the basis of securities sold on an account-by-account basis; and requires a basis reduction for any §30D credit claimed on new qualified plug-in electric drive motor vehicles.

**H. Tax Extenders and AMT Relief Act of 2008 (P. L. 110-343, October 3, 2008):**

This Act amends operative provisions of the Code as follows: allows income averaging for amounts received from the Exxon Valdez litigation and allows retirement plan contributions to be made from such amounts; increases the alternative simplified research credit and makes other changes to research credit provisions; extends the up-to-\$250-above-the-line deduction for teachers' out-of-pocket expenses through 2009; provides disaster relief for Midwest disaster areas (e.g., deductions for capitalizable expenditures, longer replacement period for involuntarily converted property, relaxed retirement plan provisions, etc.); extends the election to claim an itemized deduction for state and local general sales taxes through 2009; provides shorter recovery periods for certain types of property; increases charitable

contribution limits/deduction for contributions of wholesome food inventory; extends increased deduction for contributions of book inventory to schools and computers through 2009; extends election to expense certain capital items through 2009; extends the above-the-line deduction for higher education expenses through 2009; extends rule allowing tax-free treatment of IRA distributions donated to charity through 2009; tightens rules regarding taxation of nonqualified deferred compensation received from certain tax-indifferent corporation and partnerships; extends rule including specified payments in unrelated business taxable income through 2009; and extends the rule that S corporation's charitable contribution of property reduces shareholder's basis only by contributed property's basis through 2009.

**I. Fostering Connections to Success and Increasing Adoptions Act of 2008 (P. L. 110-351, October 7, 2008):**

The only operative provision of this Act amends the definition of "qualifying child" for purposes of the dependency exemption.

**J. Worker, Retiree, and Employer Recovery Act of 2008 (P. L. 110-458, December 23, 2008):**

The operative provisions of this Act include the following: relief for employer-sponsors of pension plans by relaxing funding provisions; taxpayer relief by waiving the required minimum distribution requirement for 2009, by requiring plans to offer nonspouse beneficiary rollovers starting in 2010, and by allowing distributions from designated Roth accounts to be rolled over to a Roth IRA.

**III. TECHNICAL CORRECTIONS**

The Department requests that the following technical corrections be made to the bill:

Section 3, amending §235-2.4, HRS: Add Code section 63(c)(3) (additional standard deduction for aged and blind) to the list of inoperative sections enumerated in §235-2.4(a)(1), HRS (as amended by the bill).

Section 4, amending §235-2.45, HRS: Delete the last sentence ("The cost-of-living adjustment determined under section 1(f)(3) of the Internal Revenue Code shall be operative for the purpose of applying section 685(c)(3) under this chapter.") of §235.2.45(c), HRS (as amended by the bill), which addresses the operation of Code section 685.

New Section 5: Amend §235-55.6(e)(6)(B), HRS, by replacing the reference to section 151(c)(3) of the Code with a reference to section 152(f)(1) of the Code.

New Section 6: Amend §235-55.91(e)(1)(A) and (e)(1)(B) by replacing the reference to section 152(a)(1) to (8) of the Code with a reference to section 152(a) of the Code; and

amend §235-55.91(e)(1)(C) by replacing the reference to section 152(a)(9) of the Code with a reference to section 152(d)(2)(H) of the Code.

#### **IV. REVENUE IMPACT**

It is estimated that the conformity bill will reduce income tax revenues by a net amount of \$3.4 million for fiscal year 2010, as explained further below.

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 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. The accompanying dollar figures represent the estimated increase/(decrease) in tax revenues associated with the provision.

#### **\$13,950 net increase – Heartland, Habitat, and Horticulture Act of 2008 (P. L. 110-246, June 18, 2008):**

- (\$25,650) – Retroactive two-year extension (through 2009) of rules allowing individuals to deduct qualified conservation contributions up to 50% of contribution base (100% for farmers), with a 15-year carryover period.
- (\$5,400) – Deduction for expenses incurred after December 31, 2008 for endangered species recovery expenditures.
- \$45,000 – Disallowance of deduction for excess farm losses for tax years beginning after December 31, 2009.

#### **(\$120,832) net decrease – Housing Assistance Tax Act of 2008 (P. L. 110-289, July 30, 2008):**

- (\$150,000) – 9% minimum yield in computing the low income housing tax credit; increased state allocation authority from \$2 per capita to \$2.20 per capita for low income housing tax credits for 2008 and 2009.
- \$18,750 – Taxation of portion of gain on sale of principal residence attributable to periods of nonqualified use.
- \$10,418 – Relaxed rules regarding investments in foreign investments and health care facilities, and prohibited transactions for real estate investment trusts.

**(\$163,125) net decrease – Emergency Economic Stabilization Act of 2008 (P. L. 110-343, October 3, 2008):**

- (\$163,125) –Mortgage forgiveness exclusion for mortgage debt discharged before January 1, 2013.

**(\$161,550) net decrease – Energy Improvement and Extension Act of 2008 (P. L. 110-343, October 3, 2008):**

- (\$12,600) – 10-year recovery period for "smart" electric meters and distribution grid systems.
- (\$148,950) –Deduction for cost of energy efficient building property placed in service before January 1, 2014.

**(\$1,653,311) net decrease – Tax Extenders and AMT Relief Act of 2008 (P. L. 110-343, October 3, 2008):**

- (\$250,625) – Above-the-line deduction for up to \$250 in out-of-pocket classroom expenses for tax years beginning before January 1, 2010.
- (\$100,000) – Itemized deduction for state and local general sales taxes for tax years beginning before January 1, 2010.
- (\$192,150) – 5-year recovery period for farm machinery and equipment placed in service in 2009.
- (\$417,690) – 15-year straight-line recovery period for qualified leasehold improvements, qualified restaurant improvements, and qualified retail improvements placed in service before January 1, 2010.
- (\$53,775) – Enhanced charitable contribution deduction for contributions of apparently wholesome food inventory made before January 1, 2010.
- (\$24,525) – Enhanced deduction for contributions of book inventory to elementary and secondary schools made before January 1, 2010.
- (\$120,150) – Enhanced deduction for qualified computer contributions made before January 1, 2010.
- (\$207,000) – Expensing of qualified environmental remediation expenditures paid or incurred before January 1, 2010.
- (\$188,333) – Tax-free treatment of IRA distributions donated to charity made before January 1, 2010.
- (\$99,063) – Reduction of S corporation shareholder's basis only by basis of property contributed to a charity for tax years beginning before January 1, 2010.

**(\$1,351,775) net decrease – Worker, Retiree, and Employer Recovery Act of 2008 (P. L. 110-458, December 23, 2008):**

- (\$2,000,000) – Waiver of required minimum distribution from qualified retirement plans and individual retirement accounts for 2009.



- \$530,550 – Allows plan to fund less than 100% of funding shortfall.
- \$117,675 – Allows multi-employer plan sponsors to elect to retain prior year's plan status for the plan year beginning during the period beginning October 1, 2008 through September 30, 2009.

The \$2,000,000 estimated revenue loss caused by the waiver of the required minimum distribution will be incurred whether or not Hawaii conforms to this provision. Because this provision passed after the Administration's budget was finalized, this \$2 million estimated revenue loss has not been factored into the executive budget.



# TAXBILLSERVICE

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SUBJECT: INCOME, Conformity to federal code

BILL NUMBER: SB 971, SD-1; HB 1153, HD-1 (Similar)

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 12/31/08 for tax years beginning after 12/31/08.

The following sections of the Internal Revenue Code (IRC) shall **not** be operable for Hawaii income tax purposes: sections 63(c)(1)(B) (relating to the additional standard deduction), 63(c)(1)(C) (relating to the real property tax deduction), 63(c)(1)(D) (relating to the disaster loss deduction), 63(c)(4) (relating to inflation adjustments), 63(c)(7) (defining the real property tax deduction), 63(c)(8) (defining the disaster loss deduction), and 63(f) (relating to additional amounts for the aged or blind).

IRC section 165 (with respect to losses) shall be operative for Hawaii income tax purposes except that the amount prescribed by section 165(h)(1) (relating to the limitation per casualty) shall be a \$100 limitation per casualty, and sections 165(h)(3)(A) and 165(h)(3)(B) (both of which relate to special rules for losses in federally declared disasters) shall **not** be operative for purposes of this chapter.

IRC section 172 (with respect to net operating loss deductions) shall be operative as further provided in section HRS 235-7(d), except that sections 172(b)(1)(J) and 172(j) (both of which relate to qualified disaster losses) of the Internal Revenue Code shall **not** be operative for purposes of this chapter

The increase in IRC Section 179 (with respect to the election to expense certain depreciable business assets) dollar amounts to \$250,000 for tax years beginning after 2008, the increase in section 179 investment limitation to \$800,000 for tax years beginning after 2008, the special rules for qualified disaster assistance property in section 179(e) shall **not** be operative for purposes of this chapter.

IRC section 198A (with respect to the expensing of qualified disaster assistance expenses) shall **not** be operative for purposes of this chapter.

IRC section 451 (which provided general rules for taxable year of inclusion) shall be operative, except that the provisions of 451(i)(3) and 451(i)(6) as they relate to a qualified electric utility shall **not** be operative for purposes of this chapter.

IRC section 1221 (with respect to the definition of capital assets) shall be operative except that the provisions of section 301 of Public Law 110-343, which provide that gain or loss from the sale or exchange of any applicable preferred stock by any applicable financial institution (such terms being defined by Public Law 110-343) shall be treated as ordinary income or loss, shall **not** be operative. A sale or exchange of any applicable preferred stock by any applicable financial institution (as those terms

are defined by section 301 of Public Law 110-343) shall be treated as a sale of a capital asset and taxed accordingly.

EFFECTIVE DATE: SB - Tax years beginning after December 31, 2008; HB - Upon approval

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-1 (09) 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.

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) Economic Stimulus Act of 2008 (P.L. 110-185); (2) Food, Conservation and Energy Act of 2008 (P.L. 110-234); (3) Heroes Earnings Assistance and Relief Tax Act of 2008 (P.L. 110-245); (4) Housing and Economic Recovery Act of 2008 (P.L. 110-289); (5) Emergency Economic Stabilization Act of 2008 (P.L. 110-343); (6) Fostering Connections to Success and Increasing Adoptions Act of 2008 (P.L. 110-351); and (7) Worker, Retiree, and Employer Recovery Act of 2008 (P.L. 110-458).

Among the sections that are being made inoperative for Hawaii state income tax purposes are those which provide additional tax benefits such the additional deduction for real property taxes for taxpayers who take the federal standard deduction or the bonus depreciation for businesses. Others are geographically specific such as the special rules for gains and losses in a federally declared disaster area such as the flooding in the Midwest last year.

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 such as those for energy efficiency. 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 Hawaii can afford.

Digested 3/2/09