

TAXBILLSERVICE

126 Queen Street, Suite 304

TAX FOUNDATION OF HAWAII

Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Conformity to federal code

BILL NUMBER: SB 971, SD-2

INTRODUCED BY: Senate Committee on Ways and Means

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.

In administering the provisions of sections 410 to 417 (with respect to special rules relating to pensions, profit sharing, stock bonus plans, etc.), sections 418 to 418E (with respect to special rules for multi-employer plans), and sections 419 and 419A (with respect to treatment of welfare benefit funds) of the Internal Revenue Code, the department of taxation shall adopt rules under chapter 91 relating to the specific requirements under such sections and to such other administrative requirements under those sections as may be necessary for the efficient administration of sections 410 to 419A; provided that, except for the first \$50,000, each year, employer paid pension income shall be taxable under 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 provides 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: July 1, 2050; applicable to tax years beginning after December 31, 2008

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 as 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.

Currently, all pension income is exempt under the state income tax law. This measure would subject employer paid pension income, except the first \$50,000 of employer paid pension income, to state income taxation.

Under the federal law, pensions are taxed upon distribution. The first Tax Review Commission stated that "the state should aim for the same degree of broadness of tax base achieved by the Federal government as a minimum tax policy goal." One alternative recommended was to subject all pension income to the income tax.

Under current law, taxpayers do not include any form of pension income from a defined benefit plan in gross income whether it be \$10,000 or \$100,000 per year. However, in recent years as the cost of these defined benefit plans became too costly for many private employers to fund, they jettisoned the defined benefit plans in favor of deferred compensation plans and plans established under 401(k) of the Code. At the encouragement of the federal tax laws, more and more workers are setting aside resources for their retirement years in the form of 401(K) plans, Self-Employed Pension Plans (SEP) and Individual Retirement Accounts (IRA). The benefits of these deferred compensation types of plans remain taxable. Thus, the current pension exclusion discriminates against those retirees who do not receive retirement benefits from a defined benefit plan. One solution to this dichotomy of treating retirement income would be to repeal the current exclusion. This may be political suicide as current retirees would suddenly be subject to income taxes on what has been tax exempt income.

On the other hand, with the percentage of Hawaii's population age 65 and older projected to grow from 13% in 2000 to 24.5% in 2030 and to 30% by 2075, policy makers need to address this inequity. On one hand, the 2001-2003 Tax Review Commission suggested doing nothing but to continue to monitor the situation because they did not see a growing elderly population as having a deleterious impact on state tax revenues as there are fewer and fewer retirees who will receive exempt defined benefit pensions.

Consideration might be given to taking care of the problem of low-income retirees' reliance on taxable pension income. This situation, the Commission suggested, may be addressed by increasing the lowest income tax bracket, increasing the amount of the personal exemption and the standard deduction so that those in the very low-income brackets receiving pension income are not subjected to state income taxes. This would then allow policy makers to treat pension income as taxable having provided a means threshold before imposing the tax.

The other suggestion made by the Commission was to make the application of the state income tax on pension income prospective so that current retirees and those who based their retirement planning on the current exclusion are not penalized. Thus, one strategy would be to set an effective date ten years out - to grandfather those who are already in retirement while forewarning those who are still in the workforce that pension income will one day be taxed.

Lest one believe that seniors are the innocent victims, it should be noted that exemption from taxation leads those who are so favored to believe that they can demand more and more public services without any consequences. Allowing this form of income to completely escape income taxation will perpetuate this lack of accountability.