

HB 1089

HD 1

NEIL ABERCROMBIE
GOVERNOR

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SENATE COMMITTEE ON WAYS AND MEANS

TESTIMONY OF THE DEPARTMENT OF TAXATION REGARDING HB 1089 HD1 RELATING TO CONFORMITY TO THE INTERNAL REVENUE CODE

TESTIFIER: **FREDERICK D. PABLO, DIRECTOR OF TAXATION
(OR DESIGNEE)**

COMMITTEE: **WAM**

DATE: **March 17, 2011**

TIME: **9:00 AM**

POSITION: **SUPPORT**

This measure is the annual bill to update the Hawaii income tax law to conform to changes to the Internal Revenue Code that occurred in calendar year 2010.

The Department of Taxation (Department) **supports** this bill to continue in conformity with the Internal Revenue Code.

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 2010, Congress enacted tax measures with the hope of stimulating the economy and providing taxpayer relief. The following federal legislation contains tax provisions that were analyzed to determine whether Hawaii should conform to the enacted Internal Revenue Code changes:

1. To Accelerate the Income Tax Benefits for Charitable Cash Contributions for the Relief of the Victims of the Earthquake in Haiti (P.L. 111-126) enacted January 22, 2010;
2. Temporary Extension Act of 2010 (P.L. 111-144) enacted on March 2, 2010;
3. Hiring Incentives to Restore Employment Act ("HIRE") (P.L. 111-147) enacted on March 18, 2010;

4. Patient Protection and Affordable Care Act (P.L. 111-148) enacted on March 23, 2010 ("Patient Protection Act");
5. Health Care and Education Reconciliation Act of 2010 (P.L. 111-152) enacted on March 23, 2010 ("Health Care Act");
6. Federal Aviation Administration Extension Act of 2010 (P.L. 111-153) enacted on March 25, 2010;
7. Continuing Extension Act of 2010 (P.L. 111-157) enacted on April 15, 2010;
8. Airport and Airway Extension Act of 2010 (P.L. 111-161) enacted on April 28, 2010;
9. Haiti Economic Lift Program Act of 2010 (P.L. 111-171) enacted on May 24, 2010;
10. To Clarify the Health Care provided by the Secretary of Veterans Affairs that Constitute Minimum Essential Coverage (P.L. 111-173) enacted on May 27, 2010;
11. Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (P.L. 111-192) enacted on June 25, 2010;
12. Airport and Airway Extension Act of 2010, Part II (P.L. 111-197) enacted on June 29, 2010;
13. Homebuyer Assistance and Improvement Act of 2010 (P.L. 111-198) enacted on July 2, 2010;
14. Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) enacted on July 21, 2010;
15. Unemployment Compensation Extension Act of 2010 (P.L. 111-205) enacted on July 22, 2010;
16. 2010 Burmese Import Restrictions Act (P.L. 111-210) enacted on July 27, 2010;
17. Airline Safety and Federal Aviation Administration Extension Act of 2010 (P.L. 111-216) enacted on August 1, 2010;
18. Education Jobs and Medicaid Assistance Act (P.L. 111-226) enacted on August 10, 2010;
19. United States Manufacturing Enhancement Act of 2010 (P.L. 111-227) enacted on August 11, 2010;
20. Firearms Excise Tax Improvement Act of 2010 (P.L. 111-237) enacted on August 16, 2010;

21. Small Business Jobs Act of 2010 (P.L. 111-240) enacted on September 27, 2010;
22. Airport and Airway Extension Act of 2010, Part III (P.L. 111-249) enacted on September 23, 2010;
23. Plain Writing Act of 2010 (P.L. 111-274) enacted on October 13, 2010;
24. The Claims Resettlement Act of 2010 (P.L. 111-291) enacted on December 8, 2010;
25. Medicare and Medicaid Extenders Act of 2010 (P.L. 111-309) enacted on December 9, 2010;
26. Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312) enacted on December 17, 2010 ("Tax Relief Act");
27. Surface Transportation Extension Act of 2010, Part II (P.L. 111-322) enacted on December 22, 2010;
28. Regulated Investment Company Modernization Act of 2010 (P.L. 111-325) enacted on December 22, 2010;
29. Airport and Airway Extension Act of 2010, Part IV (P.L. 111-329) enacted on December 22, 2010;
30. Omnibus Trade Act of 2010 (P.L. 111-344) enacted on December 29, 2010.

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, 2010. Generally, subtitle A, chapter 1, refers to Code sections 1 through 1400T.

Section 3 of this bill amends section 235-2.35, by providing that the information reporting provisions that were enacted last year are not conformed to as of a certain date, but that subsequent amendments to those sections would automatically apply. At the federal level, as it existed on April 1, 2010, Internal Revenue Code section 6041(h) required that 1099s be issued to corporations that receive payments of \$600 or more. On September 27, 2010, the Small Business Jobs Act of 2010 renumbered section 6041(h) as 6041(i) and added a reporting requirement for persons renting real estate as 6041(h). Sections 6041(h) and (i) are very controversial and may be repealed. To be clear that if the old section 6041(h) or any of the other sections listed in section 235-2.35 are repealed at the federal level, then those sections will also be repealed at the state level, the language regarding the sections as in effect as of April 1, 2010 was deleted. **In addition, SB 1316 needs to be amended to replace the reference to subsection (h) with subsection (i) due to the renumbering of the section.**

Section 4 of this bill amends section 235-2.4, HRS, with respect to conformity provisions for the following sections of the Code:

- §68 (Limitation on Itemized Deduction) – to not conform to the delay in the return of the limitation on itemized deductions. The limitation was scheduled to return for the 2011 tax year but is now delayed until the 2013 tax year at the federal level. The phase out of itemized deductions would apply to individuals whose adjusted gross income exceeds \$100,000 (\$50,000 in the case of a separate return by a married individual). The amount of the itemized deductions would be reduced by the lesser of 3% of the amount over \$100,000 or 80% of the itemized deductions for the taxable year. By not conforming to the delay, the limitation on itemized deductions would apply to the 2011 and 2012 tax years for Hawaii state income tax purposes (Tax Relief Act provision);
- §105 (amounts received under accident and health plans) – to conform to the extension of the exclusion from gross income for employer-provided health coverage to any taxpayer's child who has not reached age 27 as of the end of the tax year from age 19 or age 24, if a student (Health Care Act provision);
- §127 (educational assistance programs) – to conform to the extension for employer-provided educational assistance and the exclusion for graduate-level courses through 2012 (Tax Relief Act provision);
- §164(b)(5) (deduction for taxes paid) – to not conform to the extension of the provision of an election to deduct general excise tax in lieu of the deduction for state income taxes paid through tax year 2011. The Abercrombie-Schatz administration in a separate bill has proposed the elimination of the deduction for state income taxes paid, therefore, the administration proposes not conforming to the extension of the election to deduct general excise tax in lieu of Hawaii income taxes paid (Tax Relief Act provision);
- §179 (expensing certain depreciable business assets) – to not conform to the increased thresholds for expensing certain business assets. The bill makes clear that for Hawaii income tax purposes, taxpayers can expense up \$25,000 of aggregate cost of the property but if the cost of the property exceeds \$200,000 then the \$25,000 limitation is reduced by the amount in excess of \$200,000. **Section 179(b)(5) needs to be renumbered as section 179(b)(6).** (Tax Relief Act 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 (Tax Relief Act provision);

- §213 (medical expense deduction) – to conform to raising the floor on the medical expense deduction to 10% of adjusted gross income beginning in 2013 for most people and in 2018 for senior citizens (Patient Protection Act provision); and
- §408(d)(8) (Individual Retirement Accounts) – to conform to the extension of the rules allowing tax-free distributions of up to \$100,000, if donated to charity, through the 2011 tax year (Tax Relief Act).

Basis of Assets Transferred at Death

In addition, this bill will provide that assets transferred at death generally will receive a step-up in basis to fair market value for persons dying in 2010 or thereafter. Therefore, section 1014 of the Internal Revenue Code will apply and section 1022 of the Internal Revenue Code will be repealed for persons dying after December 31, 2009. For persons dying in 2010, at the federal level, the executor may elect to either pay the estate tax and receive a step-up in basis under IRC section 1014 or not pay the estate tax and receive a carryover basis under IRC section 1022. At the federal level, prior to these amendments providing this election, there was no estate tax at the federal level. This bill does not adopt an election mechanism for persons dying during 2010 for Hawaii purposes. Hawaii had an estate tax in 2010 for persons dying after May 1, 2010. Therefore, for Hawaii purposes, all persons dying in 2010 will receive a step-up in basis under this bill.

REVENUE IMPACT

It is estimated that the conformity bill will result in an approximate revenue loss of \$2.9 million for fiscal year 2012 and \$400,000 for fiscal year 2013, and an approximate revenue gain of \$2.8 million for 2014 and \$3.6 for 2015.

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

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SUBJECT: INCOME, Conformity to federal code

BILL NUMBER: HB 1089, 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 12/31/10 for tax years beginning after 12/31/10.

Amends HRS section 235-2.4 to provide that: (1) section 68 (with respect to the overall limitation on itemized deductions) of the Internal Revenue Code (IRC) shall be operative, except that sections 68(f) and 68(g) shall not be operative; (2) section 164 of the IRC (with respect to taxes) shall be operative except that section 164(b)(5) shall not be operative; (3) section 179 (with respect to the election to expense certain depreciable business assets) of the IRC shall be operative except that the aggregate cost provided in section 179(b)(1) that may be taken into account under subsection 179(a) for any taxable year shall not exceed \$25,000 and the amount at which the reduction in limitation provided in section 179(b)(2) begins shall be \$200,000 for any taxable year.

The amendments made to HRS section 235-2.4 shall not be repealed when HRS section 235-2.4(a)(2) is repealed and reenacted on December 31, 2015, pursuant to Act 60, SLH 2009.

EFFECTIVE DATE: July 1, 2030

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-01 (11) 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) The Hiring Incentives to Restore Employment Act (HIRE), (PL 111-147, enacted March 18, 2010); (2) Small Business Jobs Act of 2010 (PL 111-240, enacted September 27, 2010); and (3) Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (PL 111-312, enacted December 17, 2010).

It should be noted that a number of Code amendments in the last few years focused on incentives to help jumpstart 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.

This measure makes section 68 (with respect to the overall limitation on itemized deductions) of the IRC operable for state income tax purposes but does not adopt the phase out of the limitation or the December 31, 2009 sunset date. On the federal level, taxpayers with adjusted gross income above a certain amount lost part of their deduction for personal exemptions and itemized deductions. The provision began in the early 1990's and was repealed on December 31, 2009. The itemized deduction reduction called for a reduction of itemized deductions of 3% of the amount that a taxpayer's adjusted gross income (AGI) exceeds the threshold amount. The amount the taxpayer can claim as a deduction is reduced once AGI goes above a certain level for the taxpayer's filing status. The threshold is indexed annually for inflation and for 2009 the levels were: married filing joint/single - \$166,800; and married filing separately - \$83,400. While this provision has expired on the federal level on December 31, 2009, it is unclear which income levels this provision is applicable for Hawaii income tax purposes as the federal levels were indexed for inflation. Thus, it is questionable whether or not Section 68 even exists.

This measure also provides that section 164(b)(5) shall not be operable for Hawaii income tax purposes. The American Jobs Creation Act of 2004 permitted taxpayers to deduct the amount they paid in sales taxes on their federal income tax returns if they itemize deductions, if they kept all of their receipts. As an alternative, the Internal Revenue Service (IRS) has optional sales tax tables based on a taxpayer's income. Amounts paid for a motor vehicle and an aircraft, boat, home or home building materials may be added to the optional tax tables. While this provision was made operable for Hawaii income tax purposes by Act 60, SLH 2005, this measure would now make this provision inoperable for Hawaii state income tax purposes.

The measure also amends the applicability of Section 179 (with respect to the election to expense certain depreciable business assets) of the IRC to provide that the aggregate cost provided in section 179(b)(1) that may be taken into account under subsection 179(a) for any taxable year shall not exceed \$25,000 and the amount at which the reduction in limitation provided in section 179(b)(2) begins shall be \$200,000 for any taxable year.

Digested 3/15/11