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SUBJECT: INCOME, Conformity to federal code

BILL NUMBER: HB 2605, 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 12/31/11 for tax years beginning after 12/31/11.

Amends HRS section 235-2.35 to delete “(1) Section 6041 as applicable to persons under section 6041(h) (with respect to information returns at the source for certain corporations).”

EFFECTIVE DATE: Upon approval

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-01 (12) 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 Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011, (P.L. 112-9), enacted April 14, 2011; and (2) Temporary Payroll Tax Cut Continuation Act of 2011, (P.L. 112-78), enacted December 23, 2011. Because of the political gridlock in Congress, relatively few amendments to the Code were adopted. However, it should be noted that the state legislature has over the past two years chosen to digress from conformity by limiting itemized deductions and disallowing the deductibility of state income and sales taxes. Reconsideration should be given to restoring unlimited itemized deductions and the deductibility of state income and sales taxes in order to maintain conformity between the state and federal laws.

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

Digested 3/19/12