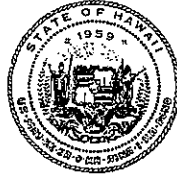


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RANDOLF L. M. BALDEMOR
DEPUTY DIRECTOR

To: The Honorable Marcus Oshiro, Chair
And Members of the House Finance Committee

Date: February 15, 2012

Time: 2:00p.m.

Place: Conference Room 308, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. 2605 Relating to Conformity to the Internal Revenue Code

H.B. 2605 is the Department of Taxation's (Department) annual bill to update the Hawaii income tax law to conform to changes to the Internal Revenue Code (Code) that occurred in calendar year 2011. The Department supports this bill to provide conformity with the Internal Revenue Code.

In 2011, Congress enacted very few tax measures. The following federal legislation contains tax provisions that were analyzed to determine whether Hawaii should conform to the enacted Internal Revenue Code changes:

1. "James Zadroga 9/11 Health and Compensation Act of 2010," P.L. 111-347, enacted on January 2, 2011;
2. "Surface Transportation Extension Act of 2011," P.L. 112-5, enacted on March 4, 2011;
3. "Airport and Airway Extension Act of 2011," P.L. 112-7, enacted on March 31, 2011;
4. "Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011," P.L. 112-9, enacted on April 14, 2011;
5. "Department of Defense and Full-Year Continuing Appropriations Act, 2011," P.L. 112-10, enacted on April 11, 2011;
6. "Airport and Airway Extension Act of 2011, Part II," P.L. 112-16, enacted on June 1, 2011;

7. "Airport and Airway Extension Act of 2011, Part III," P.L. 112-21, enacted on June 22, 2011;
8. "Airport and Airway Extension Act of 2011, Part IV," P.L. 112-27, enacted on July 15, 2011;
9. "Surface and Air Transportation Programs Extension Act of 2011," P.L. 112-30, enacted on September 16, 2011;
10. "To Extend the Generalized System of Preferences, and for other purposes," P.L. 112-40, enacted on October 13, 2011;
11. "United States-Korea Free Trade Agreement Implementation Act," P.L. 112-41, enacted on October 21, 2011;
12. "United States-Colombia Trade Promotion Agreement Implementation Act," P.L. 112-42, enacted on October 21, 2011;
13. "United States-Panama Trade Promotion Agreement Implementation Act," P.L. 112-43, enacted on October 21, 2011;
14. "3% Withholding Repeal and Job Creation Act," P.L. 112-56, enacted on November 21, 2011; and
15. "Temporary Payroll Tax Cut Continuation Act of 2011," P.L. 112-78, enacted on December 23, 2011.

The Department recommends nonconformance for those Internal Revenue Code provisions that we have consistently not conformed to in the past.

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, 2011. Generally, subtitle A, chapter 1, refers to Code sections 1 through 1400T. The majority of changes to the Internal Revenue Code in the federal acts cited above do not involve provisions of subtitle A, chapter 1, of the Internal Revenue Code or provisions to which the state currently conforms, such as the work opportunity credit for veterans and the credit for health care coverage.

Section 3 of this bill amends section 235-2.35, by deleting the information reporting requirement for corporations that was repealed at the federal level in the "Comprehensive 1099 Taxpayer Protection and Repayment of Exchange Subsidy Overpayments Act of 2011," P.L. 112-9, enacted on April 14, 2011. Prior to its repeal and re-designation, section 6041(h) required that Form 1099s be provided to corporations, which was first enacted in 2010. Due to complaints from businesses concerning this new requirement, Congress repealed this reporting requirement in 2011 before it ever became effective. This bill would conform to the federal repeal of this information reporting requirement at the state level.

Thank you for the opportunity to provide comments.

TAXBILLSERVICE

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SUBJECT: INCOME, Conformity to federal code

BILL NUMBER: SB 2867; HB 2605 (Identical)

INTRODUCED BY: SB by Tsustui by request; HB by Say by request

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 law.

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. This version of the bill is a short form proposal with specific amendments to be forthcoming from the department of taxation.

Digested 2/3/12