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To: The Honorable David Y. Ige, Chair
and Members of the Senate Committee on Ways and Means

Date: Wednesday, February 6, 2013
Time: 9:00 a.m.
Place: Conference Room 211, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: S.B. 1184 Proposed S.D.1 Relating to Conformity of the Hawaii Income Tax Law to the Internal Revenue Code

The Department of Taxation (Department) strongly supports S.B. 1184 to provide conformity with the Internal Revenue Code.

S.B. 1184 is the Department's annual bill to update the Hawaii income tax law to conform to changes to the Internal Revenue Code that occurred in the prior calendar year.

In 2012, Congress enacted very few tax measures; however, on January 2, 2013, Public Law 112-240, also known as the "American Taxpayer Relief Act of 2012" was enacted (Taxpayer Relief Act). The Taxpayer Relief Act included many provisions which extended or retroactively extended tax features that expired or were set to expire. To accommodate the late enactment of the Taxpayer Relief Act, the Department is recommending that the dates in section 235-2.3 and 235-2.5 be amended. The following federal legislation containing tax provisions have been analyzed to determine whether Hawaii should conform to the enacted Internal Revenue Code changes:

1. "Airport and Airway Extension Act of 2012," P.L. 112-91, enacted on January 26, 2012;
2. "FAA Air Transportation Modernization and Safety Improvement Act," P.L. 112-95, enacted on February 6, 2012;
3. "Middle Class Tax Relief and Job Creation Act of 2012," P.L. 112-96, enacted on February 22, 2012;
4. "Surface Transportation Extension Act of 2012," P.L. 112-102, enacted on March 30, 2012;

5. "Temporary Surface Transportation Extension Act of 2012," P.L. 112-140, enacted on June 29, 2012;
6. "Moving Ahead for Progress in the 21st Century Act," P.L. 112-141, enacted on June 29, 2012;
7. "To amend the African Growth and Opportunity Act," P.L. 112-163, enacted on August 10, 2012;
8. "American Taxpayer Relief Act of 2012," P.L. 112-240, enacted on January 2, 2013;

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 January 2, 2013. The date was extended to conform to the Taxpayer Relief Act because it affected many income tax provisions that Hawaii conforms to. Generally, subtitle A, chapter 1, refers to Code sections 1 through 1400T.

Section 3 of this bill amends section 235-2.5, by amending the date as of which the Internal Revenue Code would be adopted.

Thank you for the opportunity to provide comments.

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SUBJECT: INCOME, Conformity to federal code

BILL NUMBER: SB 1184, Proposed SD-1

INTRODUCED BY: Senate Committee on Ways and Means

BRIEF SUMMARY: Amends HRS sections 235-2.3(a) and 235-2.5(c) by changing the date references to make the Internal Revenue Code (IRC) applicable for state income tax purposes as it was amended on January 2, 2013 for tax years beginning after 12/31/12.

EFFECTIVE DATE: Tax years beginning after December 31, 2012

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-01 (13) 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) American Taxpayer Relief Act of 2012 (P.L. 112-240) (signed on January 2, 2013); (2) Moving Ahead for Progress in the 21st Century Act of 2012 (P.L. 112-141); and (3) Middle Class Tax Relief and Job Creation Act of 2012 (P.L. 112-96).

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.

Although the annual conformity bill has adopted the Code as of the last day of the year preceding the session taking such action, it should be pointed out that the American Taxpayer Relief Act of 2012 which helped to avoid the “fiscal cliff” was signed into law on January 2, 2013. While many of the provisions relating to the definition of income were made effective retroactively, this draft of the bill fixes the effective date for Code provisions as the date that ATRA 2012 was signed into law which is January 2, 2013 to insure that any and all amendments to sections of the Code which are operative for state purposes are updated.

Digested 2/4/13