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To: The Honorable Sylvia Luke, Chair
and Members of the House Committee on Finance

Date: Thursday, March 27, 2014
Time: 2:00 p.m.
Place: Conference Room 308, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: S.B. No. 2886, S.D. 1 Relating to the Conformity
of the Hawaii Income Tax Law to the Internal Revenue Code

The Department of Taxation (Department) strongly **supports** S.B. 2886, S.D. 1, an Administration measure, to conform the Hawaii income tax law to the Internal Revenue Code (Code) as of December 31, 2013.

S.B. 2886, S.D. 1 amends the Hawaii Revised Statutes (HRS) to conform the Hawaii income tax law to the Internal Revenue Code as of December 31, 2013. The United States Congress enacted very few tax measures during 2013. The following pieces of legislation were analyzed to determine if amendments to conformity are necessary:

1. "To amend the Internal Revenue Code of 1986 to include vaccines against seasonal influenza with the definition of taxable vaccines," P.L. 113-15, enacted June 25, 2013;
2. "To rename section 219(c) of the Internal Revenue Code of 1986 as the Kay Bailey Hutchison Spousal IRA," P.L. 113-22, enacted July 25, 2013;
3. "Continuing Appropriations Act, 2014," P.L. 113-46, enacted October 17, 2013;
4. "Fallen Firefighters Assistance Tax Clarification Act of 2013," P.L. 113-63, enacted December 20, 2013.

The Department identified no necessary changes to conformity due to the above federal tax measures. 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, as amended on December 31, 2013. Generally, subtitle A, chapter 1, refers to Code sections 1 through 1400T.

Section 3 of this bill amends section 235-2.4, HRS, to update conformity to various individual Code sections and to make various technical amendments. Section 235-2.4(b), HRS, is amended to reflect the repeal of two provisions already inoperative for Hawaii income tax purposes. Section 235-2.4(g), HRS, is amended to clean up the dates of inoperability of Code sections 132(f)(2)(A) and (B), due to the extension of those two provisions.

Section 3 of this bill also amends conformity to Code section 164 in order to disallow a double tax benefit for income taxes paid to a foreign jurisdiction. The amendment disallows the deduction for foreign income taxes paid if the taxpayer has taken the credit allowed under section 235-55, HRS.

Section 4 of this bill amends section 235-2.45(e), HRS, to provide that the 100 per cent exclusion for gain on certain small business stock is not operative for Hawaii income tax purposes.

Section 5 of this bill amends section 235-2.45(h), HRS, to continue nonconformance to the shortened recognition periods provided in Code section 1374(d)(7)(B), (C), and (D).

Section 6 of this bill amends section 235-2.45(m), HRS, to provide for nonconformance to the provisions of Subchapter C of the Code that deal with administrative procedures. The amendment maintains conformity with provisions of Subchapter C of the Code that define the substantive tax treatment. The amendment will allow the Department to impose its own administrative procedures to this area of law to remain consistent with the administration of the remainder of Hawaii income tax law.

Section 7 of this bill amends section 235-2.5(c), HRS, by removing the date contained in that section. This amendment will alleviate the need to amend section 235-2.5(c), HRS, each year but will maintain the meaning and intention of that section.

Thank you for the opportunity to provide comments.

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SUBJECT: INCOME, Conformity to Internal Revenue Code

BILL NUMBER: SB 2886, SD-1

INTRODUCED BY: Senate Committee on Ways and Means

EXECUTIVE SUMMARY: This annual conformity measure, in addition to updating the conformity date to the Internal Revenue Code (IRC), proposes two substantive changes.

State Tax Deduction: The bill proposes a limitation analogous to IRC section 275, which disallows a deduction for foreign taxes taken as a foreign tax credit. As such, it is consistent with the conformity principle.

Partnership Audit Procedures: The bill proposes that Hawaii decouple from the federal partnership audit procedures. The department has said it wants to do this to impose its own administrative procedures, but hasn't told us what they are.

Hawaii does conform to federal partnership audit procedures for electing large partnerships, and does not conform to federal procedures for S corporations. To simplify administration, these three areas should be consistent.

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 12/31/13 for tax years beginning after 12/31/13.

Amends HRS section 235-2.4 to provide that with respect to IRC section 164 (with respect to taxes), section 164(a) (3) shall not be operative for any amounts for which a credit under HRS section 235-55 has been claimed.

Amends HRS section 235-2.45 to provide that, with respect to IRC chapter 63 subchapter C relating to TEFRA partnership audit and assessment procedures, Hawaii will conform only to IRC sections 6221, 6222, and 6231.

EFFECTIVE DATE: Upon approval, applies to tax years beginning after 12/31/13

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-01 (14) 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. Although it might seem simpler for the legislature to adopt the Internal Revenue Code as it exists now and in the future, it is not constitutional to do that because lawmakers have the power and duty to determine which federal amendments, if any, to pick up for state purposes.

This year, the department proposes to make two substantive changes to the way the Internal Revenue Code is applied in Hawaii.

Section 164: In the federal context, IRC section 164 allows a deduction for state and local, and foreign, income, war profits, and excess profits taxes. In Hawaii, HRS section 235-55 provides a resident taxpayer a credit for income tax paid to another jurisdiction. The theory is that both Hawaii (which taxes residents on worldwide income) and the other jurisdiction have both taxed the resident on the same income, so Hawaii will offer relief for the tax paid to the other jurisdiction. HRS section 235-55 already provides that this credit is not available for foreign taxes, or taxes imposed by U.S. possessions, that are or may be the subject of the federal foreign tax credit. However, the Hawaii law does not prevent a deduction for the foreign taxes, which makes sense because Hawaii law doesn't allow the credit and thus there is no double-dipping. This measure would prevent taxpayers from claiming the credit under HRS section 235-55 and the itemized deduction for state taxes under IRC section 164 (a)(3).

TEFRA audit provisions: The TEFRA audit provisions are a complex set of procedural provisions designed to make it easier for the government to audit partnerships and their partners. Before the adoption of these provisions, the government couldn't audit and assess a partnership because a partnership doesn't pay tax. Instead, it would have to assess all of the partners. And if some of those partners were themselves partnerships or S corporations, then it could take a good amount of legwork to set up the assessment properly. The TEFRA procedures make it easier to coordinate both an assessment of tax or a refund request by focusing on the partnership instead of the partners. This bill proposes to decouple from most of these provisions, effectively turning back the clock to pre-TEFRA. The department of taxation stated in its testimony before Ways and Means that: "The amendment will allow the Department to impose its own administrative procedures to this area of law to remain consistent with the administration of the remainder of Hawaii income tax law." However, it isn't clear what these new procedures are or why they are necessary.

In addition, the legislature may want to think about whether it does or does not want to conform to these procedures with regard to partnerships (this provision), electing large partnerships (IRC chapter 63 subchapter D, to which Hawaii conforms), and S corporations (IRC section 6037, to which Hawaii presently does not conform).