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

Date: Wednesday, February 26, 2014
Time: 5:00 p.m.
Place: Conference Room 308, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. No. 2000, Relating to Tax Relief

The Department of Taxation (Department) strongly opposes H.B. 2000 and provides the following for your consideration. The Department opposes this measure because it will create substantial refund claims, and because Congress' actions regarding this section are uncertain, the potential revenue impact is unknown.

H.B. 2000 amends the State income tax law with respect to net operating loss deductions and the election to expense certain depreciable business assets so as to conform to federal tax law provisions. The measure would be effective upon approval and apply to taxable years beginning after December 31, 2012.

First, the Department is concerned that retroactively changing the State income tax law at this point will generate substantial refund claims. Under current State tax law, computer software is not an allowable Internal Revenue Code (IRC) §179 property. This measure would alter that and allow computer software to be currently deducted up to the IRC §179 limits. The retroactive conformity to IRC §179 to match the federal deduction limit of \$500,000 is also expected to substantially increase the tax refund claims as a result of such conformity. These refund claims will be generated by increasing the amount that may be deducted as an expense (versus depreciated over the life of the asset), thereby substantially decreasing taxable income.

Second, the Department strongly opposes the retroactive application of this measure because it would not alter a person's behavior with respect to 2013, since that year has already passed. Moreover, a decision whether to place property in service in 2013 has already been made and cannot be reversed. If the Legislature is inclined to fully conform to the federal tax law, however, it should only do so on a prospective basis. To retroactively conform to the federal law will only serve to reward taxpayers with tax incentives that were not available when the

transactional decisions were made.

Third, it should be noted that although the current deduction limit under IRC §179 for 2014 is only \$25,000, there is no guarantee that Congress will not retroactively alter this limit. For example, the American Taxpayer Relief Act of 2012 retroactively increased the IRC §179 limit for 2012 to \$500,000, while at the same time increasing the 2013 limit to \$500,000. If Congress were to take similar actions for the 2014 tax year, full conformity without limitations, this means that Hawaii could be raising its current deduction limit of \$25,000 to \$500,000 or more.

Finally, the Department is concerned with the implied repeal of Hawaii Revised Statutes (HRS) §235-7(d), which currently governs the Hawaii treatment of Net Operating Losses (NOLs). Under HRS §235-7(d) and the rules promulgated thereunder, a taxpayer is prohibited from making an election under IRC §172(b)(3) to waive the carryback period if the NOLs occurred in the taxpayer's business prior to the taxpayer entering business in this State. The Department believes that this may enable taxpayers to use NOLs generated by non-Hawaii operations to reduce or eliminate any Hawaii tax liability.

For the foregoing reasons, the Department strongly opposes this measure. Thank you for the opportunity to provide testimony.

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SUBJECT: INCOME, Adopt federal net operating loss deduction and election to expense certain depreciable business assets

BILL NUMBER: HB 2000

INTRODUCED BY: McKelvey, Awana, Brower, Cachola, Luke, Mizuno, Woodson, Yamane and 4 Democrats

BRIEF SUMMARY: Amends HRS section 25-2.4 to provide that Section 172 (with respect to net operating loss deductions) of the Internal Revenue Code (IRC) shall be fully operative for state income tax purposes.

Section 179 (with respect to the election to expense certain depreciable business assets) of the IRC shall be fully operative for state income tax purposes.

EFFECTIVE DATE: Tax years beginning after December 31, 2012

STAFF COMMENTS: Under the current law, IRC section 172 (with respect to net operating loss deductions) is operable for Hawaii income tax purposes except that sections 172(b)(1)(J) and 172(j) (both of which relate to qualified disaster losses) of the IRC shall not be operative for Hawaii income tax purposes. The conformity measure of 2009, Act 133, adopted these restrictions as the department of taxation stated that if a federally declared disaster occurs in Hawaii, the state could provide other tax relief (e.g., tax credits) at that time when the cost of such tax relief is more readily ascertainable.

As a result of Act 133, SLH 2009, and Act 91, SLH 2011, IRC section 179 (with respect to the election to expense certain depreciable business assets), is currently operable for Hawaii income tax purposes with the following restrictions: (1) the aggregate cost provided in section 179(b)(1) which may be taken into account under section 179(a) for any taxable year shall not exceed \$25,000; (2) the amount at which the reduction in limitation provided in section 179(b)(2) begins shall not exceed \$200,000 for any taxable year; and (3) the following shall not be operative for purposes of this chapter: (a) Defining section 179 property to include computer software in section 179(d)(1); (b) inflation adjustments in section 179(b)(5); (c) irrevocable election in section 179(c)(2); and (d) special rules for qualified disaster assistance property in section 179(e). These limitations were adopted since Hawaii historically does not conform to the increased maximum deduction and phase out amounts and does not conform to the special rules for qualified disaster assistance property.

While adoption of this measure would fully conform Hawaii's income tax law to IRC section 172 (with respect to net operating loss deductions) and IRC section 179 (with respect to the election to expense certain depreciable business assets) the adoption of this measure will result in a revenue loss due to the deductibility of the higher dollar amounts.

Digested 2/25/14