HOUSE OF REPRESENTATIVES
TWENTY-SEVENTH LEGISLATURE, 2014
STATE OF HAWAII

H.B. NO. 2612

A BILL FOR AN ACT

RELATING TO TAXATION.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF HAWAII:

1 SECTION 1. In 1996, Congress enacted Section 529 of the
2 Internal Revenue Code of 1986, as amended, authorizing tax-
3 deferred college savings plans now referred to as "529 Plans".
4 Section 529 authorizes states to establish these programs to
5 assist and encourage families to set aside funds for future
6 higher education expenses. Most states with an income tax offer
7 some kind of in-state tax deduction or credit for contributions
8 as an incentive for residents to participate in these college
9 savings plans.
10 The purpose of this Act is to encourage Hawaii families to
11 save for college and to increase participation rates in college
12 savings plans by providing a state income tax deduction for
13 contributions to a qualified 529 college savings plan.
14 SECTION 2. Section 235-7, Hawaii Revised Statutes, is
15 amended to read as follows:
16 "§235-7 **Other provisions as to gross income, adjusted**
17 **gross income, and taxable income.** (a) There shall be excluded
18 from gross income, adjusted gross income, and taxable income:

1 (1) Income not subject to taxation by the State under the
2 Constitution and laws of the United States;
3 (2) Rights, benefits, and other income exempted from
4 taxation by section 88-91, having to do with the state
5 retirement system, and the rights, benefits, and other
6 income, comparable to the rights, benefits, and other
7 income exempted by section 88-91, under any other
8 public retirement system;
9 (3) Any compensation received in the form of a pension for
10 past services;
11 (4) Compensation paid to a patient affected with Hansen's
12 disease employed by the State or the United States in
13 any hospital, settlement, or place for the treatment
14 of Hansen's disease;
15 (5) Except as otherwise expressly provided, payments made
16 by the United States or this State, under an act of
17 Congress or a law of this State, which by express
18 provision or administrative regulation or
19 interpretation are exempt from both the normal and
20 surtaxes of the United States, even though not so
21 exempted by the Internal Revenue Code itself;

1 (6) Any income expressly exempted or excluded from the
2 measure of the tax imposed by this chapter by any
3 other law of the State, it being the intent of this
4 chapter not to repeal or supersede any express
5 exemption or exclusion;
6 (7) Income received by each member of the reserve
7 components of the Army, Navy, Air Force, Marine Corps,
8 or Coast Guard of the United States of America, and
9 the Hawaii National Guard as compensation for
10 performance of duty, equivalent to pay received for
11 forty-eight drills (equivalent of twelve weekends) and
12 fifteen days of annual duty, at an:
13 (A) E-1 pay grade after eight years of service;
14 provided that this subparagraph shall apply to
15 taxable years beginning after December 31, 2004;
16 (B) E-2 pay grade after eight years of service;
17 provided that this subparagraph shall apply to
18 taxable years beginning after December 31, 2005;
19 (C) E-3 pay grade after eight years of service;
20 provided that this subparagraph shall apply to
21 taxable years beginning after December 31, 2006;

1 (D) E-4 pay grade after eight years of service;
2 provided that this subparagraph shall apply to
3 taxable years beginning after December 31, 2007;
4 and
5 (E) E-5 pay grade after eight years of service;
6 provided that this subparagraph shall apply to
7 taxable years beginning after December 31, 2008;
8 (8) Income derived from the operation of ships or aircraft
9 if the income is exempt under the Internal Revenue
10 Code pursuant to the provisions of an income tax
11 treaty or agreement entered into by and between the
12 United States and a foreign country; provided that the
13 tax laws of the local governments of that country
14 reciprocally exempt from the application of all of
15 their net income taxes, the income derived from the
16 operation of ships or aircraft that are documented or
17 registered under the laws of the United States;
18 (9) The value of legal services provided by a legal
19 service plan to a taxpayer, the taxpayer's spouse, and
20 the taxpayer's dependents;
21 (10) Amounts paid, directly or indirectly, by a legal
22 service plan to a taxpayer as payment or reimbursement

1 for the provision of legal services to the taxpayer,
2 the taxpayer's spouse, and the taxpayer's dependents;
3 (11) Contributions by an employer to a legal service plan
4 for compensation (through insurance or otherwise) to
5 the employer's employees for the costs of legal
6 services incurred by the employer's employees, their
7 spouses, and their dependents;
8 (12) Amounts received in the form of a monthly surcharge by
9 a utility acting on behalf of an affected utility
10 under section 269-16.3; provided that amounts retained
11 by the acting utility for collection or other costs
12 shall not be included in this exemption;
13 (13) Amounts received in the form of a cable surcharge by
14 an electric utility company acting on behalf of a
15 certified cable company under section 269-134;
16 provided that any amounts retained by that electric
17 utility company for collection or other costs shall
18 not be included in this exemption; and
19 (14) One hundred per cent of the gain realized by a fee
20 simple owner from the sale of a leased fee interest in
21 units within a condominium project, cooperative
22 project, or planned unit development to the

1 association of owners under chapter 514A or 514B, or
2 the residential cooperative corporation of the
3 leasehold units.
4 For purposes of this paragraph:
5 "Fee simple owner" shall have the same meaning as
6 provided under section 516-1; provided that it shall
7 include legal and equitable owners;
8 "Legal and equitable owner", and "leased fee
9 interest" shall have the same meanings as provided
10 under section 516-1; and
11 "Condominium project" and "cooperative project"
12 shall have the same meanings as provided under section
13 514C-1.
14 (b) There shall be included in gross income, adjusted
15 gross income, and taxable income:
16 (1) Unless excluded by this chapter relating to the
17 uniformed services of the United States, cost-of-
18 living allowances and other payments exempted by
19 section 912 of the Internal Revenue Code, but section
20 119 of the Internal Revenue Code nevertheless shall
21 apply; and

1 (2) Unless expressly exempted or excluded as provided by
2 subsection (a)(6), interest on the obligations of a
3 State or a political subdivision thereof.
4 (c) The deductions of or based on dividends paid or
5 received, allowed to a corporation under chapter 1, subchapter
6 B, part VIII of the Internal Revenue Code, shall not be allowed.
7 In lieu thereof there shall be allowed as a deduction the entire
8 amount of dividends received by any corporation upon the shares
9 of stock of a national banking association, qualifying
10 dividends, as defined in section 243(b) of the Internal Revenue
11 Code, received by members of an affiliated group, or dividends
12 received by a small business investment company operating under
13 the Small Business Investment Act of 1958 (Public Law 85-699)
14 upon shares of stock qualifying under paragraph (3), seventy per
15 cent of the amount received by any corporation as dividends:
16 (1) Upon the shares of stock of another corporation, if at
17 the date of payment of the dividend at least ninety-
18 five per cent of the other corporation's capital stock
19 is owned by one or more corporations doing business in
20 this State and if the other corporation is subjected
21 to an income tax in another jurisdiction (but

1 subjection to federal tax does not constitute
2 subjection to income tax in another jurisdiction); and
3 (2) Upon the shares of stock of a bank or insurance
4 company organized and doing business under the laws of
5 the State;
6 (3) Upon the shares of stock of another corporation, if at
7 least fifteen per cent of the latter corporation's
8 business, for the taxable year of the latter
9 corporation preceding the payment of the dividend, has
10 been attributed to this State.
11 However, except for national bank dividends, the deductions
12 under this subsection are not allowed when they would not have
13 been allowed under section 243 of the Internal Revenue Code, as
14 amended by Public Law 85-866, by reason of subsections (b) and
15 (c) of section 246 of the Internal Revenue Code. For the
16 purposes of this subsection fifteen per cent of a corporation's
17 business shall be deemed to have been attributed to this State
18 if fifteen per cent or more of the entire gross income of the
19 corporation as defined in this chapter (which for the purposes
20 of this subsection shall be computed without regard to source in
21 the State and shall include income not taxable by reason of the
22 fact that it is from property not owned in the State or from a

1 trade or business not carried on in the State in whole or in
2 part), under section 235-5 and the other provisions of this
3 chapter, shall have been attributed to the State and subjected
4 to assessment of the taxable income therefrom (including the
5 determination of the resulting net loss, if any).

6 (d) (1) For taxable years ending before January 1, 1967,
7 the net operating loss deductions allowed as
8 carrybacks and carryovers by the Internal Revenue Code
9 shall not be allowed. In lieu thereof the net
10 operating loss deduction shall consist of the excess
11 of the deductions allowed by this chapter over the
12 gross income, computed with the modifications
13 specified in paragraphs (1) to (4) of section 172(d)
14 of the Internal Revenue Code, and with the further
15 modification stated in paragraph (3) hereof; and shall
16 be allowed as a deduction in computing the taxable
17 income of the taxpayer for the succeeding taxable
18 year;

19 (2) (A) With respect to net operating loss deductions
20 resulting from net operating losses for taxable
21 years ending after December 31, 1966, the net
22 operating loss deduction provisions of the

1 Internal Revenue Code shall apply; provided that
2 there shall be no net operating loss deduction
3 carried back to any taxable year ending prior to
4 January 1, 1967;
5 (B) In the case of a taxable year beginning in 1966
6 and ending in 1967, the entire amount of all net
7 operating loss deductions carried back to the
8 taxable year shall be limited to that portion of
9 taxable income for such taxable year which the
10 number of days in 1967 bears to the total days in
11 the taxable year ending in 1967; and
12 (C) The computation of any net operating loss
13 deduction for a taxable year covered by this
14 subsection shall require the further
15 modifications stated in paragraphs (3), (4), and
16 (5) of this subsection;
17 (3) In computing the net operating loss deduction allowed
18 by this subsection, there shall be included in gross
19 income the amount of interest which is excluded from
20 gross income by subsection (a), decreased by the
21 amount of interest paid or accrued which is disallowed
22 as a deduction by subsection (e). In determining the

1 amount of the net operating loss deduction under this
2 subsection of any corporation, there shall be
3 disregarded the net operating loss of such corporation
4 for any taxable year for which the corporation is an
5 electing small business corporation;
6 (4) No net operating loss carryback or carryover shall be
7 allowed by this chapter if not allowed under section
8 172 of the Internal Revenue Code;
9 (5) The election to relinquish the entire carryback period
10 with respect to a net operating loss allowed under
11 section 172(b)(3)(C) of the Internal Revenue Code
12 shall be operative for the purposes of this chapter;
13 provided that no taxpayer shall make such an election
14 as to a net operating loss of a business where such
15 net operating loss occurred in the taxpayer's business
16 prior to the taxpayer entering business in this State;
17 and
18 (6) The five-year carryback period for net operating
19 losses for any taxable year ending during 2001 and
20 2002 in section 172(b)(1)(H) of the Internal Revenue
21 Code as it read on December 31, 2008, shall not be
22 operative for purposes of this chapter; and

1 (7) The election for the carryback for 2008 or 2009 net
2 operating losses of small businesses as provided in
3 section 172(b)(1)(H) of the Internal Revenue Code as
4 it read on December 31, 2009, shall not be operative
5 for purposes of this chapter.
6 (e) There shall be disallowed as a deduction the amount of
7 interest paid or accrued within the taxable year on indebtedness
8 incurred or continued, (1) to purchase or carry bonds the
9 interest upon which is excluded from gross income by subsection
10 (a); or (2) to purchase or carry property owned without the
11 State, or to carry on trade or business without the State, if
12 the taxpayer is a person taxable only upon income from sources
13 in the State.
14 (f) Losses of property as the result of tidal wave,
15 hurricane, earthquake, or volcanic eruption, or as a result of
16 flood waters overflowing the banks or walls of a river or
17 stream, or from any other natural disaster, to the extent of the
18 amount deductible, under this chapter, not compensated for by
19 insurance or otherwise, may be deducted in the taxable year in
20 which sustained, or at the option of the taxpayer may be
21 deducted in equal installments over a period of five years, the

1 first such year to be the calendar year or fiscal year of the
2 taxpayer in which such loss occurred.
3 (g) The following annual deductions from gross income
4 shall be allowed for contributions to a qualified tuition plan
5 established pursuant to section 529 of the Internal Revenue
6 Code:
7 (1) Up to $5,000 for individual taxpayers;
8 (2) Up to $5,000 for married couples filing separate
9 returns; provided that each spouse may claim a
10 deduction up to $5,000; and
11 (3) Up to $10,000 for married couples filing joint
12 returns, individuals filing as the head of households,
13 or individuals filing as surviving spouses.
14 If the amount of the deduction exceeds the taxpayer's taxable
15 income for the taxable year the contribution is made, the excess
16 deduction may be used as a deduction against the taxpayer's
17 taxable income in subsequent tax years until the excess
18 deduction is exhausted."
19 SECTION 3. New statutory material is underscored.
20 SECTION 4. This Act, upon its approval, shall apply to
21 taxable years beginning after December 31, 2013; provided that
22 amendments made to section 235-7, Hawaii Revised Statutes, by

1 section 2 of this Act, shall not be repealed when that section
2 is reenacted on January 1, 2018, by section 3 of Act 166,
3 Session Laws of Hawaii 2007, as amended by section 5 of Act 220,
4 Session Laws of Hawaii 2012.
5

INTRODUCED BY: ______________________

JAN 23 2014

H.B. NO. 2612

Report Title:
529 College Savings Plan; Tax Deduction

Description:
Provides an annual deduction of $5,000 per individual or $10,000 for a married couple filing jointly against their taxable income for contributions made to a college savings plan established under section 529 of the Internal Revenue Code.

The summary description of legislation appearing on this page is for informational purposes only and is not legislation or evidence of legislative intent.

WRITTEN ONLY

TESTIMONY BY KALBERT K. YOUNG
DIRECTOR, DEPARTMENT OF BUDGET AND FINANCE
STATE OF HAWAII
TO THE HOUSE COMMITTEE ON HIGHER EDUCATION
ON
HOUSE BILL NO. 2612

February 4, 2014

RELATING TO TAXATION

House Bill No. 2612, proposes to provide for an annual state income tax deduction of $5,000 per individual or $10,000 for a married couple filing jointly, against taxable income, for contributions made to a college savings plan established under section 529 of the Internal Revenue Code (commonly known as 529 college savings plans).

The Department appreciates the intent of the bill to encourage and provide incentives for individuals and families to save and invest funds for higher education. In 2002, the State of Hawaii established its 529 college savings program pursuant to Chapter 256 Hawaii Revised Statutes. Administered by the Department of Budget & Finance, "HI529 Hawaii's College Savings Program" exists to assist and encourage families to set aside funds for future college and higher education expenses. As currently written, HB2612 would allow a Hawai'i state income tax deduction for contributions made to any state's 529 plan. Opening up to any 529 plan would place it at an unknown level of risk for revenue loss, as the number of state tax filing individuals that have any of the nation's over one-hundred 529 plans, is unknown and may be substantial. From a fiscal

sustainability outlook, the Department cautions against such an open-ended State tax deduction with an unknown revenue impact.

The Department also would caution the structure of H.B. No. 2612 from a tax policy perspective as well. Granting a tax credit or deduction on contributions on the front-end while also giving a tax-free benefit on the back-end essentially means that there is a double-benefit of tax sheltering. However, if the Legislature were to proceed with H.B. No. 2612 in its current financial format, the Department would recommend the bill be amended to provide that the deduction from income be available to only those residents who participate in the State's HI529 program. Potential revenue loss can then be estimated as we have program information available. Based on 3,726 state resident accounts and Hawaii's top tax rate, a rough estimate of the maximum tax revenue loss would be approximately $4 million.

Should such a tax deduction be considered, the Department would like to note that this would provide taxpayers with a double tax benefit. The first being the deduction from gross income when funds are contributed into a plan, and the second being the tax-free treatment of the investment income when withdrawn for qualified higher education expenses. This structure would create a number of tax loop holes. Also, this would potentially allow taxpayers to contribute funds into a plan and obtain the tax benefit and then subsequently withdraw the funds for non-qualified purposes, albeit with a penalty.

In closing, the Department recognizes that a tax deduction would provide a significant incentive to Hawai'i families to save for college but strongly recommends that

the tax deduction be provided only to residents who contribute to the State of Hawaii's HI 529 College Savings Program, as this will provide for measurable revenue impact.

Thank you for the opportunity to provide testimony on this bill.

NEIL ABERCROMBIE
GOVERNOR

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LT. GOVERNOR

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To: The Honorable Isaac W. Choy, Chair
and Members of the House Committee on Higher Education

Date: Tuesday, February 4, 2014
Time: 2:01 P.M.
Place: Conference Room 309, State Capitol

From: Frederick D. Pablo, Director
Department of Taxation

Re: H.B. 2612, Relating to Taxation

The Department of Taxation (Department) appreciates the intent of H.B. 2612 to support higher education and presents the following comments for the Committee's consideration.

H.B. 2612 creates an income tax deduction for amounts contributed to qualified tuition plans established under Section 529 of the Internal Revenue Code, which Hawaii income tax law conforms to. Section 529 of the Internal Revenue Code allows states to sponsor programs that allow contributions to qualifying educational accounts that grow tax-free for purposes of financing certain qualifying education costs. Hawaii's 529 college savings plan is vested in Chapter 256, Hawaii Revised Statutes (HRS), and is overseen by the Department of Budget & Finance.

The Department notes that currently, contributions to a qualified tuition program are not deductible for income tax purposes. These contributions (sometimes referred to as the basis or investment in the account) are recovered ratably with earnings (if any) upon distribution, whether or not it is for a qualified purpose. Currently, if a distribution is not for a qualified purpose, participants in qualified tuition programs pay income tax only on the earnings associated with the distribution and do not pay income tax on the basis that is returned with the distribution. This is because the original contribution to the plan was made with after tax dollars-i.e. monies on which income tax had already been paid.

If this measure is adopted, however, the State basis of the investment will not have been subject to income tax because this measure would exempt contributions up to the limit from the income tax when made. The Department has serious concerns that this would enable taxpayers

to make substantial gifts to beneficiaries on a tax free basis, since distributions from a 529 plan can be made for any purpose and not just a qualified purpose. It should be noted that very few states offer such exemption from income tax for contributions made to a 529 plan for this reason.

If the Committee wishes to advance this measure, the Department suggests that proposed subsection (g) of section 235-7, HRS, be moved and renumbered as subsection (a)(15). Subsection 235-7, HRS, as currently enacted, contains the exclusions from income tax.

The Department also suggests subsection (g) be amended as follows to clarify that the deduction amount is the amount contributed during the taxable year:

> (g) The following annual deductions from gross income shall be allowed for contributions to a qualified tuition plan during the taxable year established pursuant to section 529 of the Internal Revenue Code:

The Department notes that this measure allows for the carryforward of any unused deduction until exhausted. This type of deduction carryforward is not common and the Department suggests its deletion. However, if the Committee wishes to provide for this type of carryforward, the Department suggests the following technical amendment:

> If the amount of the deduction exceeds the taxpayer's gross income, adjusted gross income, and taxable income for the taxable year the contribution is made, the excess deduction may be used as a deduction against the taxpayer's gross income, adjusted gross income, and taxable income in subsequent tax years until the excess deduction is exhausted.

Thank you for the opportunity to provide comments.

L E G I S L A T I V E

TAXBILLSERVICE

126 Queen Street, Suite 304 TAX FOUNDATION OF HAWAII Honolulu, Hawaii 96813 Tel. 536-4587

SUBJECT: INCOME, Deduction for qualified tuition program

BILL NUMBER: HB 2612

INTRODUCED BY: Ward, Brower, Cabanilla, Carroll, Creagan, Evans, Fukumoto, Hanohano, Johanson, Matsumoto, Thielen and 4 Democrats

BRIEF SUMMARY: Adds a new section to HRS section 235-7 to provide an annual deduction from gross income for contributions to a qualified tuition program established pursuant to IRC section 529 which shall be: (1) up to $5,000 for individual taxpayers; (2) up to $5,000 for married couples filing separately provided that each spouse may claim a deduction up to $5,000; and (3) up to $10,000 for married couples filing joint returns, individuals filing as heads of households, or individuals filing as surviving spouses.

If the amount of the deduction exceeds the taxpayer's taxable income for the taxable year in which the contribution is made, or if the contribution is in excess of the deductible amount, the excess may be used as a deduction against the taxpayer's taxable income until exhausted.

EFFECTIVE DATE: Tax years beginning after December 31, 2013

STAFF COMMENTS: This measure proposes an income tax deduction of $5,000 or $10,000 annually to encourage taxpayers to set aside funds for higher education purposes. Federal law provides for no comparable deduction because it is treated as a gift to the beneficiary (the student). See IRC section 529(c)(2)(A)(I).

IRC section 529, relating to qualified tuition programs, is operable for Hawaii income tax purposes so that there is conformity between Hawaii law and the IRC in this area. The Hawaii income tax law encourages conformity to the IRC to make compliance easier. This measure would increase the amount of nonconformity, and as such, should be adopted only if there is strong policy justification for it.

Digested 2/3/14