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

Date: Thursday, February 9, 2016
Time: 2:00 P.M.
Place: Conference Room 308, State Capitol

From: Maria E. Zielinski, Director
Department of Taxation

Re: H.B. 146, Relating to Conformity of the Income Tax Law to the Federal Internal
Revenue Code

The Department of Taxation (Department) appreciates the intent of H.B. 146, and offers the following comments for your consideration.

H.B. 146 amends Hawaii's conformity to the Internal Revenue Code (IRC) to provide that amendments to the IRC become effective for Hawaii income tax purposes as they become effective for federal income tax purposes. This is referred to in the bill as "moving date conformity". Currently, Hawaii income tax law is amended once per year to adopt amendments made to the IRC in the previous calendar year. The bill also repeals section 235-3(d) and (e), Hawaii Revised Statutes (HRS). The bill applies to taxable years beginning after December 31, 2016.

First, the Department believes that "moving date conformity" may raise more problems than it solves. By adopting "moving date conformity", the State will open itself to the direction of federal tax policy. Though it is true the Department will still be required to recommend changes to conformity provisions each year, all IRC changes, no matter how generous, will be effective for Hawaii income tax purposes until a Hawaii law addressing the provision is enacted.

Accelerated and bonus depreciation offer a good illustration of the potential consequences. These provisions allow taxpayers to severely front load deductions for the cost of assets with extended useful lives, such as heavy equipment. This means that the cost is deducted in the first few years rather than over the life of the asset, which may be ten or more years. These provisions are also often made effective retroactively. Hawaii has long refused to adopt bonus depreciation and other accelerated cost recovery provisions of the IRC. However, under "moving date conformity", these provisions would automatically become effective for Hawaii income tax purposes. Under our current system of conformity, the Department has until the next legislative session to analyze IRC changes and recommend deviations to the legislature.

Second, during the time between changes to the IRC and the next legislative session, taxpayers may have relied on amended IRC provisions for Hawaii income taxes. This reliance could later raise estoppel claims against any bill proposing to deviate from the amended provision. At the very least, it will lead to fierce opposition to any such bill. This is because such a bill would require affected taxpayers to amend their returns and effectively give back the benefit of the federal income tax provision. These amendments may also cause the taxpayer to be subject to penalties and interest because it is likely that the taxpayer will be underpaid if a tax benefit is disallowed.

Using bonus depreciation as an example, a taxpayer may purchase assets and begin depreciating them for federal and Hawaii income tax purposes, relying on an IRC change to the depreciation schedule. If a proposal to make the bonus depreciation provision inoperative were considered, these taxpayers may point out that they have already purchased the property based on the existence of bonus depreciation; that they cannot return the property; and that it is not fair to now disallow the bonus depreciation.

Third, the Department notes that the federal government routinely uses dynamic scoring to determine the revenue cost of legislative proposals. Dynamic scoring takes into account a proposal's cumulative effect on future years' economic growth when calculating the overall revenue cost. In effect, this allows the federal government to balance a proposal's current-year revenue loss with future years' revenue gain. The federal government can do this because it is able to operate on a deficit. For this reason, some changes to the IRC are made with little consideration of the short term budget effects. If moving date conformity is adopted, these short term budget effects would be imported into Hawaii's income tax, at least temporarily before a bill to limit the effect becomes law.

Fourth, regarding the repeal of sections 235-3(d) and (e), HRS, the Department agrees that these provisions are no longer necessary to Hawaii income tax purposes and supports their repeal.

Finally, if the Committee wishes to advance this measure, the Department recommends the effective date be amended to clarify when "moving date conformity" will begin to apply. The Department recommends that Section 6 of the bill be amended to read as follows:

Section 6. (a) Sections 2 and 3 of this this Act, upon its approval, [~~shall apply to taxable years beginning after December 31, 2016~~] shall apply to amendments made to the Internal Revenue Code after December 31, 2016.

(b) Section 4 of this Act, upon its approval, shall apply to taxable years beginning after December 31, 2016.

This amendment will make clear that the updated method of conforming to the IRC applies to changes to the IRC enacted after December 31, 2016. The Department notes that this specific date will still require the annual adoption of the IRC conformity bill.

Thank you for the opportunity to provide comments.

TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Adopt Moving Date Conformity

BILL NUMBER: HB 146

INTRODUCED BY: LUKE

EXECUTIVE SUMMARY: Establishes “moving date conformity,” where our income tax law automatically conforms to federal law except in areas where the legislature has chosen to decouple.

BRIEF SUMMARY: Amends HRS section 235-2.3 to provide that chapter 1 of the Internal Revenue Code is operative for state tax purposes as the same may become effective at any time or from time to time, for the taxable year.

Makes conforming amendments to HRS section 235-2.5.

Cleans up obsolete language in HRS section 235-3.

EFFECTIVE DATE: Upon approval, applies to taxable years beginning after December 31, 2016.

STAFF COMMENTS: Hawaii taxpayers will have to file an amended tax return this tax season in order to obtain some of the same deductions they enjoyed last year. How can this be? It seems very odd, but it is all due to a thorny issue called “conformity.”

In this context, conformity means similarity to the federal tax code. With conformity, we can start with federal numbers, work through a few changes, and be done. Although the process sounds easy, the devil is in the details, especially when Congress has developed a habit over the last decade of letting tax provisions expire or get very close, only deciding at the very end of the year (or, in 2012, the beginning of the next) which provisions would be extended to that year. The tax software companies almost everyone uses these days have a tough time keeping up with the brinksmanship, even without considering the state returns.

When it comes to the states, most state laws, including ours, can’t just automatically do what the Feds do. We need state lawmakers to decide which federal changes to pick up and which to reject. That is for a very good reason. Our state constitution gives our legislature the responsibility to make our tax laws. They cannot punt that duty off to anyone else, including Congress. Until our lawmakers act, software makers are in a quandary. The instructions our department of taxation gives to the software makers say this:

The following federal provisions that were adopted by Hawaii expired at the end of 2014: (1) the \$250 deduction for educator expenses, (2) the election to deduct state and local general sales taxes..., (3) the deduction for mortgage insurance premiums [sometimes known as PMI], (4) the tax-free distributions from individual retirement plans for

charitable purposes, ... At the time this instruction booklet was printed in October 2015, there was pending federal legislation that would reinstate certain provisions. If federal legislation is passed in 2015 to reinstate these provisions and these provisions are adopted by the 2016 Hawaii State Legislature, then these provisions may be claimed.

This booklet tells the software companies that their products are not to make software reflecting the law as they think it's going to be; they must reflect the current law. For example, educators who want to file their 2015 returns on time will have to go without the \$250 deduction and homeowners who pay PMI will have to forego this deduction. If and when our conformity legislation is passed, the teachers and homeowners with PMI can come back and file an amended return. This is a real hassle for them, as well as for the Department of Taxation, because all amended returns are currently processed manually.

An alternative, presented in this bill, is "moving date conformity," which is in place in 22 jurisdictions (AL, CO, CT, DE, DC, IL, KS, LA, MD, MI, MO, MT, NE, NM, NY, ND, OH, OK, PA, RI, UT, VT). In those states, changes in federal tax law automatically apply to the state tax code as they occur, but the state is given the option to pass specific legislation to decouple from any new federal law it does not like. That should give the software makers enough comfort to change the software to accommodate the vast majority of federal changes while still allowing our elected legislators to weigh in on what is best for Hawaii and eliminating the need to file as many amended returns.

Digested 2/6/2017