LEGISLATIVE TAX BILL SERVICE

TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, Deduction for Qualified Business Income

BILL NUMBER: SB 3073

INTRODUCED BY: KIM, DELA CRUZ, GALUTERIA, K. KAHELE KIDANI, NISHIHARA, S. Chang, Espero, Harimoto, Riviere, Ruderman, Shimabukuro, Taniguchi

EXECUTIVE SUMMARY: Adopts for Hawaii purposes the new federal deduction for qualified business income. This should be considered in the broader context of conformity with the IRC,

SYNOPSIS: Adds a new subsection to HRS section 235-2.4 stating that IRC section 199A (with respect to qualified business income) shall be operative for purposes of the Hawaii income tax law.

EFFECTIVE DATE: Taxable years beginning after December 31, 2017.

STAFF COMMENTS: One of the new, key components of Trump Tax is a provision important to the vast majority of small businesses. Practitioners may know it as the Section 199A deduction.

Under Trump Tax, corporations that used to see a maximum tax rate of 35% got that rate slashed to 21%. About 75% of businesses, however, are not taxed at the corporate rate. Instead, individuals who own them are taxed on the business profit at individual rates, which can go up to 37% (down from 2017's maximum of 39.6%, but not much). We need to remember that corporations are double taxed, in that they are taxed and then pay dividends which are then taxed to the recipients. But even allowing for double taxation, the corporations seem to get a big break here.

Trump Tax's answer to this anomaly is Section 199A, which tries to measure how much income has come from business operations and then gives the recipient a 20% deduction for it, which would give those earnings a benefit economically similar to a lower tax rate.

The individual tax rates were designed for most people who are wage earners. They earn money by providing their services to a business. Businesses that are service oriented, like law firms, accounting firms, or brokerage houses make their money the same way, and for that reason are not allowed the deduction—at least they aren't allowed it if they make enough money. The law provides thresholds and phase-in treatment so that those making smaller amounts of money can take the deduction as well, but those earning too much are out of luck.

Here's an example. Kenny, who owns a plumbing business, is married. His taxable income is $335,000, $300,000 of which is ordinary income that comes from the business after it pays wages of $150,000. Kenny might deduct 20% of the $300,000, or $60,000.

If Kenny instead owned an accounting firm, his taxable income is 20% of the way through the phaseout range, which for couples is $315,000 to $415,000. So, only 80% of his business income, or $240,000, is considered. He may be able to deduct 20% of the $240,000, or $48,000.

(Note that the actual law is quite a bit more complicated. There are limitations based on W-2 wages that the business paid, for instance, and others that are designed to take account of income already taxed at a lower rate such as capital gains. Those limitations don't kick in with the numbers in this example.)

Here in Hawaii, our focus over the years seems to have been to soak the individuals. Our top individual tax rate is 11%, second highest in the country, while our top corporate tax rate is 6.4%, which is much more on par with what other states are charging corporations.

This bill proposes to conform to section 199A to give some relief to the 75% of businesses that are not in corporate form, especially the small businesses.

As a technical matter, the statutory change proposed by the bill would be unnecessary because section 235-2.3(a), HRS, adopts by reference all provisions of chapter 1 of the IRC in effect on the conformity date. Assuming that the Legislature will adopt the conformity date of December 31, 2017, section 199A is part of chapter 1 and will be adopted without explicit mention in section 235-2.4, HRS.

Digested 2/3/2018