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To: The Honorable Donovan M. Dela Cruz, Chair
and Members of the Senate Committee on Ways and Means

Date: Wednesday, February 6, 2019
Time: 10:00 A.M.
Place: Conference Room 211, State Capitol

From: Linda Chu Takayama, Director
Department of Taxation

Re: S.B. 1267, Relating to Conformity to the Internal Revenue Code

The Department of Taxation (Department) strongly supports S.B. 1267, an Administration measure, and offers the following comments the Committee's consideration.

S.B. 1267 conforms Hawaii's income and estate and generation-skipping transfer taxes to the Internal Revenue Code (IRC) as of December 31, 2018. Hawaii Revised Statutes (HRS) sections 235-2.5(c) and 236E-4, require the Department to submit legislation to each regular session of the legislature to adopt the IRC as it exists on the December 31 preceding the regular session.

S.B. 1267 amends HRS section 235-2.3(a), to conform the Hawaii income tax law to the operative IRC sections of subtitle A, chapter 1, as amended as of December 31, 2018. Generally, subtitle A, chapter 1, refers to IRC sections 1-1400Z-2. S.B. 1267 also amends HRS section 236E-3, to conform the Hawaii estate and generation-skipping transfer tax law to the operative IRC sections of subtitle B, as amended as of December 31, 2018. Generally, subtitle B refers to IRC sections 2001 through 2801.

In addition to the formal changes above, S.B. 1267 makes several other amendments to conformity, as follows.

First, S.B. 1267 amends HRS sections 235-2.3(b) and 235-2.45(k) to conform to the tax benefits for opportunity zone investments and to limit those benefits to investments in opportunity zones designated by the Governor of Hawaii.

Opportunity zones and their tax benefits are defined in IRC sections 1400Z-1 and 1400Z-2. Opportunity zones are generally economically distressed areas that are specially designated by state governors. Investments in opportunity zones are eligible for substantial tax benefits, including ten years of deferral of capital gains tax owed on proceeds that are invested in

opportunity zones, up to a 15% step up in basis for the original investment in the opportunity zone, and full exemption on the capital gain from the sale of an investment in an opportunity zone (does not include the original capital gains invested in the opportunity zone).

The reasoning behind these benefits is to increase investment in economically distressed areas. The Governor has designated various areas as opportunity zones. The Department recommends that the State adopt the federal tax deferral provisions to support investments in opportunity zones in Hawaii.

Second, S.B. 1267 amends HRS section 235-2.4(ee) to provide that IRC section 512(a)(7) is not applicable for Hawaii income tax purposes. The Tax Cuts and Jobs Act of 2017 (TCJA) disallowed certain fringe benefit deductions for ordinary businesses. As a corollary, the TCJA added IRC section 512(a)(7) to increase the unrelated business taxable income (UBTI) of a tax-exempt organization for the same amounts that are disallowed as deductions to ordinary businesses.

Hawaii did not conform to the disallowance of deductions for ordinary businesses in an effort to maintain the status quo for taxpayers under Hawaii income tax. However, due to an oversight, Hawaii did conform to the increase in UBTI under IRC section 512(a)(7). Therefore, the treatment of ordinary businesses and tax-exempt organizations is inconsistent. The Department recommends rectifying this by making IRC section 512(a)(7) inoperative for purposes of Hawaii income tax law.

Third, S.B. 1267 amends HRS section 236E-6 to clarify the exemption amount for Hawaii estate and generation-skipping transfer tax law. The change will make clear that the exemption amount is fixed at the amount applicable to decedents dying on December 31, 2017.

Finally, the United States Congress enacted the following tax measures during 2018, which the Department analyzed to determine if amendments to conformity were necessary:

1. "Consolidated Appropriations Act, 2018," P.L. 115-141; enacted March 23, 2018;
2. "John S. McCain National Defense Authorization Act for Fiscal Year 2019," P.L. 115-232; enacted August 13, 2018;
3. "Tribal Social Security Fairness Act of 2018," P.L. 115-243; enacted September 20, 2018;
4. "Airport and Airway Extension Act of 2018 Part II," P.L. 115-250; enacted September 29, 2018;
5. "FAA Reauthorization Act of 2018," P.L. 115-254; enacted October 5, 2018;
6. "SUPPORT for Patients and Communities Act of 2018," P.L. 115-271; enacted October 24, 2018.

The Department analyzed each of the foregoing Acts and identified no necessary changes

to Hawaii's income tax law.

Thank you for the opportunity to provide testimony in support of this measure.

TAX FOUNDATION OF HAWAII

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SUBJECT: INCOME, ESTATE, Conformity to Internal Revenue Code

BILL NUMBER: SB 1267; HB 1041 (Identical)

INTRODUCED BY: SB by KOUCHI by request; HB by SAIKI by request

EXECUTIVE SUMMARY: Conforms the Hawaii income tax and estate and generation-skipping transfer taxes to federal changes adopted through December 31, 2018.

SYNOPSIS: 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 12/31/18 for tax years beginning after 12/31/18. Amends HRS section 236E-3 by changing the date references to make the IRC applicable for state estate and generation-skipping tax purposes as it was amended on 12/31/18 for tax years beginning after 12/31/18.

Amends HRS section 235-2.3(b) by deleting paragraph (51) relating to opportunity zones, and amending HRS section 235-2.45 by adding a new subsection (k) relating to opportunity zones. In other words, the bill proposes to conform to federal treatment of opportunity zones, as long as they are designated by the governor of this state.

Amends HRS section 235-2.4(ee) by specifying that IRC section 512(a)(7) is not operative in Hawaii.

EFFECTIVE DATE: The income tax provisions are effective to taxable years beginning after December 31, 2018; the estate and generation-skipping tax provisions apply to decedents dying or taxable transfers occurring after December 31, 2018.

STAFF COMMENTS: This is the annual conformity measure submitted by the department of taxation TAX-01 (19) 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, and in compliance with HRS section 236E-4 which requires the department to annually submit a measure to maintain state estate and generation-skipping tax conformity with the federal Internal Revenue Code.

The purpose of conformity is to update the state tax laws with those changes made to the federal Code during the past year and to adopt those changes that are appropriate for Hawaii law.

The following discusses the provisions for which State conformity is proposed to be changed.

[Opportunity Zones \(secs. 1400Z-1 and 1400Z-2 of the Code\)](#)

These were added to the federal Code by the Tax Cuts and Jobs Act, Pub. L. No. 115-97.

The TCJA provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the

sale or exchange of an investment in the qualified opportunity fund. The provision allows for the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in Section 45D(e). The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

Governors (including the chief executive of the District of Columbia) may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. If the number of low-income communities in a State is less than 100, the Governor may designate up to 25 tracts, otherwise the Governor may designate tracts not exceeding 25 percent of the number of low-income communities in the State. Governors are required to provide particular consideration to areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations.

In addition, each population census tract in each U.S. possession that is a low-income community is deemed certified and designated as a qualified opportunity zone effective on the date of enactment.

The provision provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property. The provision intends that the certification process for a qualified opportunity fund will be done in a manner similar to the process for allocating the new markets tax credit. The provision provides the Secretary authority to carry out the process.

If a qualified opportunity fund fails to meet the 90 percent requirement and unless the fund establishes reasonable cause, the fund is required to pay a monthly penalty of the excess of the amount equal to 90 percent of its aggregate assets, over the aggregate amount of qualified opportunity zone property held by the fund multiplied by the underpayment rate in the Code. If the fund is a partnership, the penalty is taken into account proportionately as part of each partner's distributive share.

Qualified opportunity zone property includes: any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property.

The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum

deferral amount, the capital gains must be recognized and included in gross income as under present law.

If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or December 31, 2026. Only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the provision.

The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional five percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain.

The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

The Secretary or the Secretary's delegate is required to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment. The report is to include an assessment of investments held by the qualified opportunity fund nationally and at the State level. To the extent the information is available, the report is to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments. The report is also to include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.

Present and Proposed State Treatment

Presently, Hawaii does not conform to the Opportunity Zone provisions of the TCJA. The bill proposes that Hawaii conform.

The Foundation notes that Hawaii does not typically conform to federal incentive provisions such as this one, but there have been exceptions.

Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for Which Deduction Is Disallowed

Tax exemption for certain organizations

Section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in section 501(c) (including among others section 501(c)(3) charitable organizations and section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in section 401(a).

Unrelated business income tax, in general

The unrelated business income tax (UBIT) generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions. An organization that is subject to UBIT and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing its exempt status. A section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities. Therefore, the unrelated trade or business activity of a section 501(c)(3) organization must be insubstantial.

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business. Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions. As a result, an organization may use a loss from one unrelated trade or business to offset gain from another, thereby reducing total unrelated business taxable income.

Organizations subject to tax on unrelated business income

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under section 501(a), including organizations described in section 501(c) (except for U.S. instrumentalities and certain charitable trusts); (2) qualified pension, profit-sharing, and stock bonus plans described in section 401(a); and (3) certain State colleges and universities.

Exclusions from Unrelated Business Taxable Income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents, unless derived from debt-financed property or from certain 50-percent controlled subsidiaries. Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students,

patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for alternative minimum tax determined after taking into account adjustments and tax preference items.

Operation of Section 512(a)(7)

Under the TCJA, unrelated business taxable income includes any expenses paid or incurred by a tax exempt organization for qualified transportation fringe benefits (as defined in section 132(f)), a parking facility used in connection with qualified parking (as defined in section 132(f)(5)(C)), or any on-premises athletic facility (as defined in section 132(j)(4)(B)), provided such amounts are not deductible under section 274. That is, the TCJA disallowed deductibility of transportation fringe benefits for nonexempt organizations; for exempt organizations providing such benefits, the organizations are required to include in their UBTI the value of the benefits and to pay tax as if that value were income.

Present and Proposed State Treatment

Presently, Hawaii conforms to the above fringe benefit provisions of the TCJA. The bill proposes that Hawaii decouple.

The Foundation notes that the above provisions will require tax-exempt organizations that do not conduct unrelated business to file a Form 990-T. The Department of Taxation requires organizations filing a 990-T to file a comparable State form, Form N-70NP, and then typically expects such organizations to register for and report General Excise Tax. GET, however, would not apply to organizations with deemed income under this federal provision. To prevent possible confusion, the Foundation has no problem with the proposed decoupling.

Digested 2/3/2019