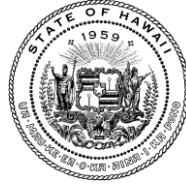


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To: The Honorable Donovan M. Dela Cruz, Chair;
The Honorable Gilbert S.C. Keith-Agaran, Vice Chair;
and Members of the House Committee on Economic Development

From: Isaac W. Choy, Director
Department of Taxation

Date: February 12, 2021
Time: 10:00 A.M.
Place: Via Video Conference, State Capitol

Re: S.B. 1195, Relating to Conformity to the Internal Revenue Code

The Department of Taxation (Department) strongly supports S.B. 1195, an Administration measure, and offers the following comments for the Committee's consideration.

S.B. 1195 conforms Hawaii's income and estate and generation-skipping transfer taxes to the Internal Revenue Code (IRC) as of December 31, 2020. Hawaii Revised Statutes (HRS) sections 235-2.3(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. 1195 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, 2019. Subtitle A, chapter 1, refers to IRC sections 1-1400A-2. H.B. 1041 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, 2020. Generally, subtitle B contains the estate tax provisions and consists of IRC sections 2001-2801.

S.B. 1195, as currently written, contains the IRC amendments made after the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). Conformity to the federal tax changes in the CARES Act were addressed in Act 13, Session Laws of Hawaii (SLH) 2020.

On December 27, 2020, the Consolidated Appropriations Act, 2021, P. L. 116-260, became law. This Act made numerous changes to the IRC relevant to Hawaii income tax. Below are the Department's recommendations regarding these changes, followed by proposed language to adopt the recommendations.

The Department recommends conforming to the following provisions:

1. Exclusion of cancellation of indebtedness income from income for new Paycheck Protection Program (PPP) loans that were not covered by the CARES Act.

Explanation: The Department supports conforming to this provision because Hawaii conformed to the exclusion of cancellation of indebtedness income for the original PPP program in the CARES Act. *See Act 13, SLH 2020.*

2. Exclusion of Economic Injury Disaster Grants (EIDL Grants) from income.

Explanation: The Department supports excluding EIDL Grants from income because these grants are akin to the PPP loans. EIDL Grants are available for a wider variety of uses, such as working capital, continuing health care benefits, etc.

3. Exclusion of loan payments made on certain small business loans from income.

Explanation: The Department supports excluding these payments from income because these are payments directly to the lender for certain small business loans. These payments are akin to EIDL Grants in that the provided monthly payments are essentially grants to the affected businesses.

4. Exclusion of certain small business grants from income.

Explanation: The Department supports excluding these grants from income for the reasons provided for the loans and grants provided above. These grants are those provided under Section 324 of the Economic Aid to Hard-Hit Small Businesses, Non-profits, and Venues Act, which are provided to businesses such as live music and entertainment venues and movie theatres.

5. Exclusion of the second recovery rebates (\$600 stimulus checks) from income.

Explanation: Conform. Hawaii conformed to the exclusion from income of the initial recovery rebates in the CARES Act. The Department believes that it is appropriate to similarly exclude the second recovery rebates from income. *See Act 13, SLH 2020.*

6. Exclusion of emergency financial aid grants received by students from income (does not apply to grants for which teaching, research, or services are required).

Explanation: Conform. These are emergency grants to undergraduate or graduate students for unexpected expenses and unmet financial need as a result of the COVID-19 pandemic. The grants are provided under section 3504 of the CARES Act and the amount is limited to the amount of the Federal Pell Grant for the year.

7. Extension of the increase the charitable deduction for food inventory to apply to contributions made through 2021.

Explanation: Hawaii conformed to the increase to this deduction as provided in the CARES Act. *See* Act 13, SLH 2020. The Department supports conforming to the extension through 2021.

8. Adoption of assorted disaster and retirement plan administration changes.

Explanation: The Department supports conforming to the disaster tax changes, which relax various withdrawal and repayment requirements for qualified retirement plans. In addition, the Department supports conforming to retirement plan changes as they are administrative in nature and Hawaii tightly conforms to federal retirement plan rules.

To conform to these provisions, the Department recommends H.B. 1041 be amended to add the following language to HRS section 235-2.3(a):

Sections 276(b)(1) (relating to subsequent paycheck protection program loans), 277 (relating to emergency financial aid grants), 278(b)(1) (relating to emergency EIDL grants and targeted EIDL advances), 278(c)(1) (relating to subsidy for certain loan payments), and 278(d)(1) (relating to grants for shuttered venue operators) of Division N of Public Law 116-260 shall be operative for purposes of this chapter. Sections 213 (relating to modification of limitations on charitable contributions) and 214 (relating to temporary special rules for health and dependent care flexible spending arrangements) of Division EE of Public Law 116-260 shall be operative for purposes of this chapter. Sections 301, 302, and 304 (relating to disaster tax relief) of Division EE of Public Law 116-260 shall be operative for purposes of this chapter. No amount received under section 272 (relating to additional 2020 recovery rebates for individuals) of Division N of Public Law 116-260 shall be included in gross income for purposes of this chapter.

The Department does not recommend conforming to the following provisions:

1. Allowance of deductions for expenses paid with proceeds of forgiven PPP loans for which the forgiven amounts were excluded from income.

Explanation: The Department does not support allowing these deductions because doing so will allow deductions for expenses paid with proceeds from forgiven loans that were not included in

income. This will result in taxpayers receiving a double benefit, as taxpayers that have received funds that neither have to be repaid nor included in income, will be able to deduct expenses paid with those excluded proceeds. As a matter of pure tax policy, the Department believes that allowing such double benefits is inappropriate.

As an example, consider the treatment of Individual Retirement Accounts (IRAs). IRAs allow taxpayers to contribute to a retirement fund and deduct the contributions from current income. However, the amounts withdrawn from the IRA later in life are included in income. Similarly, contributions to a Roth IRA are not deductible from current income, but distributions are tax exempt. Applied to IRAs, this proposal would allow deductions for contributions into an IRA, and then exclude the amounts later distributed as benefits from income as well.

If Hawaii conformed to this provision, the Department estimates the general fund revenue loss as follows:

Expected Losses (\$ millions)

FY 2021	FY 2022	FY 2023	FY 2024	FY 2025	FY 2026	TOTAL
81.4	86.1	68.9	17.2	-	-	253.5

2. Allowance of deductions for expenses paid with grant proceeds and other forgiven loan amounts that were excluded from income.

Explanation: The Department does not support allowing these deductions for the same reasons stated above. As a matter of pure tax policy, the Department believes that allowing such double benefits is inappropriate.

3. Allowance of partnerships and S corporations to treat excluded forgiven loan proceeds and grant proceeds as tax exempt income.

Explanation: The Department does not support allowing this treatment of excluded loan proceeds and grant income. Similar to the allowance of deductions above, allowing this treatment would provide partners and S corporation shareholders a double benefit as it would allow excluded forgiven loan proceeds and grants to increase the basis in their partnership interests and S corporation shares.

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 1195; HB 1041

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

EXECUTIVE SUMMARY: Conforms Hawaii income and estate and generation-skipping transfer tax laws to the Internal Revenue Code of 1986, as amended as of December 31, 2020.

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 12/31/20 for tax years beginning after 12/31/20. 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 12/31/20 for tax years beginning after 12/31/20.

EFFECTIVE DATE: The income tax provisions are effective to taxable years beginning after December 31, 2020; the estate and generation-skipping tax provisions apply to decedents dying or taxable transfers occurring after December 31, 2020.

STAFF COMMENTS: This was 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.

Digested 2/6/2021