Halftime Legislative Update

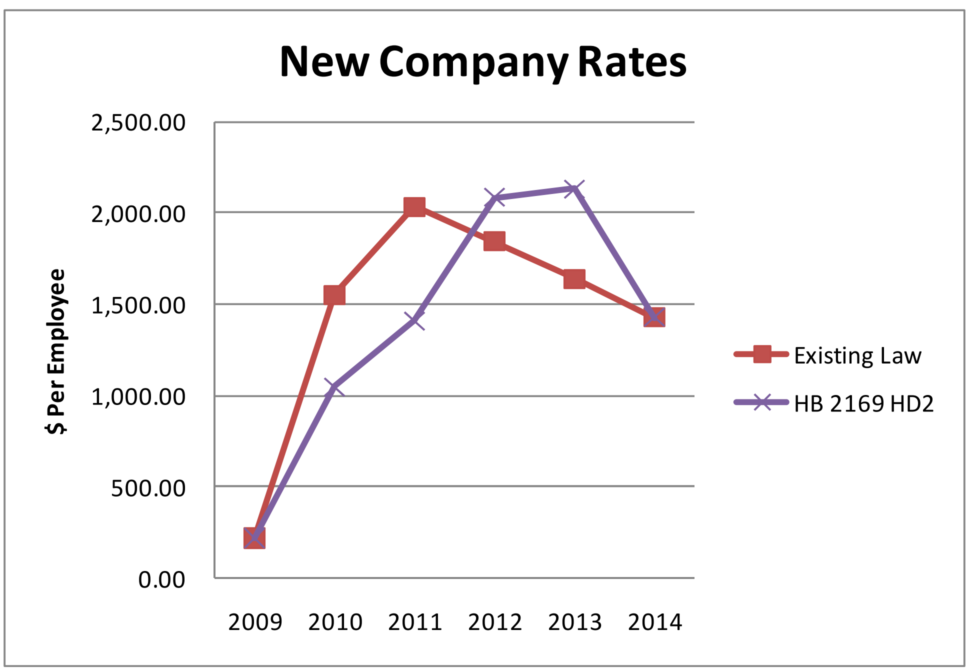
We have reached the halfway point in this year's legislative session, where bills must be positioned to cross over into the other chamber in order to survive. We have been watching a number of bills related to state taxation. In addition to a bevy of tax increase bills that are being kept alive while the State's budget picture slowly coalesces, there are bills ranging from the useful to the scratch-your-head type to the truly frightening.

SUI Reform on the Horizon – Much Closer Now!

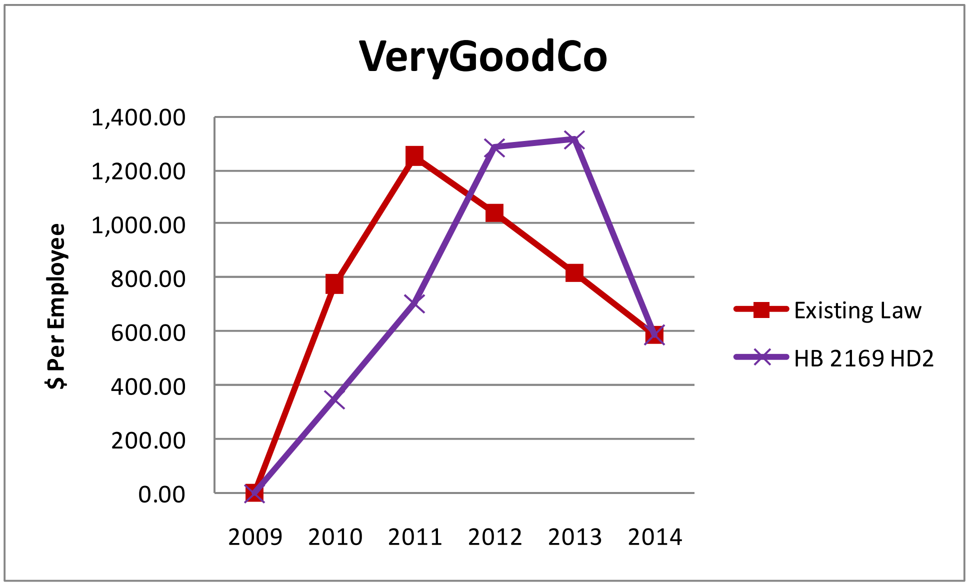
In our last update, we compared three legislative proposals to moderate what otherwise would be a meteoric rise in State Unemployment Insurance (SUI) premiums. It now seems that we have a winner: **HB 2169, HD2,** as most recently amended by the House Finance Committee, contains proposals that are similar to those put forward by the Chamber of Commerce of Hawaii. On Friday, February 26, 2010, the Senate Committees on Labor and Ways and Means held a joint hearing on this bill and decided to pass it unamended. This avoids the necessity of a House-Senate conference over the bill, meaning that it will likely be sent to the Governor in its present form, on schedule to meet the implementation deadline of March 12.

As before, we attach a series of charts. In these charts we show the amount of SUI tax to be paid for one employee earning wages at or above the taxable wage base (around $40,000). As we see, the SUI reserve fund needs to be replenished, so relief in the present must be paid for in the future; but the hope is that when the future arrives our economy will be in better shape.

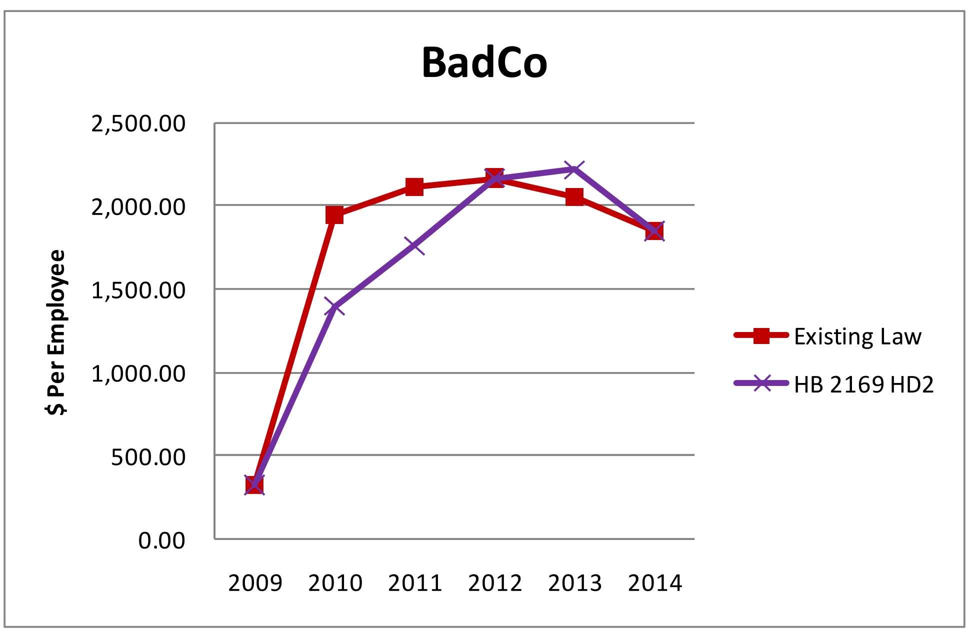
The first chart shows the tax burden for either a new company or one with a reserve ratio around zero.



The projected effects of each of the packages are relatively similar for companies with good experience, although the overall burden is smaller. Here is what it looks like for a company with a very favorable record (experience ratio at +11%):



For companies with unfavorable experience records, the effect of the relief is limited because the SUI tax rate has an overall maximum of 5.4%. Here is what it looks like for a company with an unfavorable record (experience ratio at –5%); with companies with a very unfavorable record faring comparably:



More to come soon!

Adoption of Federal Tax Changes – or Lack Thereof

Every year, the Department of Taxation submits, and the Legislature considers, a bill that would adopt some or all of the Federal changes that took place in the past year. This year's bill is significant not for what it conforms to, but for what it doesn't; it is proposed that Hawaii decouple from a large number of these federal changes. The current bills (**SB 2747 SD2, HB 2594 HD2**) are both alive and propose nonconformance in these areas, among others:

- Additional sales tax deduction on large purchases (Federal allows an itemized deduction or an addition to the standard deduction, State allows neither)
- NOL carryback (Federal allows up to 5 years, State only allows 2 years)
- Roth IRA conversions (Federal spreads the income inclusion over 4 years; Senate version taxes it in two years, House version taxes it all in the first year)
- Federal subsidy of COBRA coverage (Federal excludes it from the unemployed worker's income, State doesn't)
- Unemployment benefits (Federal excludes $2,400, State doesn't)
- Bonus depreciation (State has never allowed this)
- Section 179 expensing (State has only allowed $25,000)
- Grants for special energy property in lieu of tax credits (Federal excludes from income, State doesn't)

There are several other, more specialized areas of proposed nonconformance.

General Excise Tax as a Trust Fund Tax?

HB 2595 HD1 is a bill, sponsored by the Department of Taxation, that would deny the benefit of any lower rate, credit, deduction, or income split, unless the taxpayer files a return within one year after the return is due. It would also impose personal liability against a responsible person in a business that fails to pay the general excise tax, just as the IRS does for businesses that withhold tax from employees and fail to pay that tax over to the government. The Federal code calls the withholding tax a "trust fund" tax to justify this treatment – after withholding this tax, the money is no longer the employer's money and is being held in trust for the employees to satisfy the employees' obligations to the Government.

Accuity, among many others, testified in opposition to this bill. We pointed out that it may have the unintended effect of allowing the Federal Government to claim tax immunity from purchases on which the GET was imposed. (The Government is immune from state taxes, but now pays GET passed on to it, on the theory that the tax is imposed on the seller; but making it a trust fund tax may change the dynamic.)

The bill was also introduced in the Senate but was held in the Committee on Economic Development and Technology. The House bill will next be crossing over to the Senate.

Interest on Tax Refunds

Under current law, the State does not have to pay interest on a State tax refund if the refund order is given within 90 days after the return is filed or the return is due, whichever is later. This year, the Department of Taxation raised eyebrows when it announced that it would not pay any

2009 tax refunds until July 1st at the earliest. **HB 1948 HD1** requires refunds to taxpayers within 90 days of the filing of the return or, if earlier, the due date of the tax, discovery date of the overpayment in an amended return, or the date of determination by the Director of Taxation. It would be effective July 1, 2011.

Anti-Speculation Capital Gains Tax

SB 2575 SD2 imposes a surcharge tax on capital gains on real estate sales if the real estate was held less than 24 months. The surcharge amount depends on how long the property was held and could be up to 60% of the amount of Hawaii capital gains tax imposed. Properties that qualify for a county homeowners' exemption or properties sold by military personnel acting because of relocation orders would be exempt from the tax.

Stranding Even More Losses and Deductions

Taking a page out of the State of California's playbook, **HB 1907 HD1** suspends the ability to carry back net operating losses for losses incurred in 2009 and 2010. The second section of the bill imposes a hard maximum on the amount of itemized deductions that a taxpayer may claim ($100,000 for married filing jointly or surviving spouse, $50,000 for single or married filing separately, and $80,000 for head of household). The third section of the bill makes the Capital Goods Excise Tax Credit nonrefundable until 2015.

Let's Strand Some More Credits Too

Last year, the Qualified High Technology Business investment credit was modified so that for 2009 and 2010, it may be used only against 80% of a taxpayer's tax liability. Any excess credits are lost and do not carry over to any other year. **HB 2867 HD1** extends this treatment to a panoply of "business" income tax credits, including the capital goods excise tax credit, renewable energy technology credit, and credit for school repair and maintenance, for the years 2010 and 2011. It applies to the net income tax, the bank franchise tax and the insurance premium tax.

We Have So Many Pesky GET Exemptions...So Let's Take Them Away

HB 2877 HD1 contains a list of exemptions from the general excise tax, use tax, and the public service company tax. Under the bill, all amounts previously exempted would instead be taxed at 1% from July 1, 2010, to June 30, 2015. Among the exemptions that would be subject to the new 1% tax are:

- The deduction by a contractor for amounts paid to a subcontractor.
- The exemption for property or services exported out of state.
- The partial deduction a sublessor gets for lease rent paid for the space subleased.
- The exemption for intercompany services and interest between related entities.
- The exemptions for amounts paid by hotel operators, orchard operators, and professional employment organizations as wages and benefits.
- Several exemptions under the general excise and use taxes relating to commercial aircraft operation.

- The exemption for the sale of tangible personal property to the U.S. Government and state-chartered credit unions.
- The exemption for gross proceeds of shipbuilding and ship repair.

Conveyance Tax on a Real Property Holding Entity

Chapter 247, HRS, imposes a conveyance tax on the transfer of real property. The tax was recently increased multiple times...but is imposed only on the transfer of realty. It used to be possible to avoid the tax by transferring an entity that was holding the land, rather than the land itself. Now there is **HB 1921 HD2,** which imposes a transfer tax on the sale or transfer of a controlling interest in an entity which possesses an interest in real property valued in excess of $2,000. The transfer tax would be imposed at the conveyance tax rates.

Take That, Health Care Organizations

Mutual benefit societies and health maintenance organizations (including the major nonprofit health plans operating in Hawaii) are currently exempt from the 4.265% Hawaii insurance premium tax (highest in the nation for property and casualty insurers). **HB 2852 HD 1** subjects these organizations to the premium tax between 2010 and 2015, at a rate that phases in over the five years. Even the Department of Taxation testified in opposition to the proposed tax increase which, it said, would likely be passed on to businesses at a time when they cannot afford it.

And...Now a Special Fund for DBEDT?

HB 1926 HD2, the stated purpose of which is to ensure that the Department of Business, Economic Development, and Tourism (DBEDT) has adequate funding to continue to provide services and programs promoting economic development, imposes a surcharge of $20 on certain fees or services charged by the Departments of Taxation, Labor, Commerce and Consumer Affairs, and Land and Natural Resources between July 1, 2010, and June 30, 2015. Those surcharge revenues, plus $2 million to be taken annually from the Department of Commerce's Compliance Resolution Special Fund, are to be deposited into a new special fund which will be used to pay for the operations of DBEDT. This bill will cross over into the Senate, where it faces an uncertain future...especially given highly publicized skirmishes between DBEDT Director Ted Liu and Senate Ways and Means chair Donna Kim.

Information on these and other bills moving through the Legislature may be obtained from the Legislature's web site, www.capitol.hawaii.gov.